



Tax News Flash

- Transfer Pricing

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Samjong KPMG Transfer Pricing & Customs Service Group provides readers with Transfer Pricing 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 following is a recent Korea's tax ruling in relation to transfer pricing

The petition for corporate tax adjudication is dismissed. **< Tax Tribunal Judgment 2023seo7289, 2023.11.23 >**

Background

- The taxpayer (hereinafter, Korean taxpayer) entered into a software distribution agreement with a corporation located in the United States (hereinafter, U.S. Parent Company) and paid software royalties to U.S. parent company until 2007 and withheld tax at the reduced rate (15%) on the royalty income under the Korea-U.S. tax treaty. In 2008, Korean taxpayer paid software fees (hereinafter, disputed fees) to the Irish affiliate without withholding tax under the Korea-Ireland tax treaty, treating the corporation as the beneficial owner.
- The Tax Office determined that withholding tax on the disputed fees was not properly withheld from April 2020 to June 2022, considering the United States corporation as the beneficial owner of the disputed fees. Therefore, they applied the Korea-US tax treaty and corrected and notified the Korean taxpayer of the withholding tax for the period from April 2020 to June 2022 on December 14, 2022. The Korean taxpayer filed a petition for tax appeal on March 13, 2023, contesting this decision.

The contentious issues are as follows:

- ① Claiming that the disputed fee is business income, not royalty income.
- ② Even if the disputed fee is considered royalty income, claiming that the beneficial owner is the Irish affiliate.

Tax Office's (Defendant) Claims

- The Korean taxpayer provides related services along with the software to enable the final consumer to use it on domestic computer systems. Additionally, if necessary, the Korean taxpayer grants the final consumer the authority to replicate the program. Therefore, it is difficult to view as the purchase of generic software, as claimed by the Korean taxpayer.
- The Korean taxpayer treated the income paid to the U.S. parent company before the software distribution contract as royalty income, subject to a 15% withholding tax as per the Korea-U.S. Tax Treaty. However, since 2008, the recipient of the income has changed to the Irish affiliate without any other changes in the contract conditions. Therefore, it is reasonable to consider that the nature of the income remains the same as before.
- Furthermore, according to the royalty agreement between the Korean taxpayer and the Irish affiliate, it is explicitly stated that the Korean taxpayer can obtain the source code upon request. Therefore, the consideration paid by the Korean taxpayer to the Irish affiliate under this agreement should be regarded as royalty income, which includes the right to use the source code.
- The Irish affiliate is a conduit company and not the beneficial owner of the income, while the beneficial owner of the income is the U.S. parent company. Since 2008, the Irish affiliate has sold and distributed the programs that serve as the basis for income and has received the right to earn income from the U.S. parent company. However, it has not received any consideration for this transfer, and the U.S. parent company remains the owner of the intellectual property rights.

Taxpayer's (Plaintiff) Claims

- The disputed fee paid by the Korean taxpayer to the Irish affiliate is considered a payment for the introduction of pre-developed off-the-shelf software, and thus does not qualify as compensation for know-how or copyrights. The group strictly manages the source code of the software internally, and the software is directly delivered to end customers through websites managed by group-affiliated companies, including the Irish affiliate. Therefore, the Korean taxpayer has never exercised reproduction rights, modified, or customized the software. Therefore, the disputed fee constitutes business income rather than royalty income.
- The Irish affiliate is a company established under Irish law, and it operates as an Irish resident under Irish tax law. It employs staff to fulfill its role as a major software supplier, provides services to affiliated companies within the group, and directly engages in significant operational activities, including investment activities. Considering these factors, along with its legal and substantive ownership and control over the disputed fee, the Irish affiliate qualifies as the beneficial owner of the disputed amount. According to Article 12, Paragraph 1 of the Korea-Ireland Tax Treaty, royalties acquired and beneficially owned by a resident of Ireland are only taxable in Ireland. Therefore, even if the disputed amount is considered royalty income rather than business income, under the Korea-Ireland Tax Treaty, such income would not be subject to taxation in Korea.

Decision by Tax Tribunal

- The Korean taxpayer argues that the disputed fee is business income rather than royalty income. However, according to the contract between the Korean taxpayer and the Irish affiliate, it is specified that the Korean taxpayer can receive the source code upon request. Therefore, under this contract, the consideration paid by the taxpayer to the Irish affiliate is considered royalty income, including the right to use the source code.
- Even if the disputed fee is considered royalty income, the beneficial owner is the U.S. parent company, not the Irish affiliate. The Irish affiliate employs only a few management

personnel and transfers most of the software fees received from foreign related parties, including the Korean taxpayer, to the U.S. parent company or other affiliates.

- The intellectual property rights continue to be held by the U.S. parent company, and the Irish affiliate is considered a conduit company, having only received the right to sell and distribute the software and collect the consideration.
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