Korea Tax Updates

The Supreme Court has reversed the prior decisions and held that the Korean tax authority may impose tax on royalties derived from patents not registered in Korea (Supreme Court, September 18, 2025, 2021Du59908)

Background

In 2011, a domestic Company A ("A" or "Company A") was sued by a U.S. patent management company for patent infringement. In 2013, the parties reached a settlement under which A agreed to pay royalties of USD 1.6 million for about 40 patents registered only in the United States. When paying royalties, Company A applied the reduced withholding tax rate of 15% under Article 14(1) of the Korea–U.S. Tax Treaty and paid the withheld corporate income tax to the competent tax office.

Company A subsequently filed a claim for a refund of the corporate tax withheld, asserting that the royalties did not constitute Korean-source income as the patents were not registered in Korea.

The lower courts, relying on the principle of territoriality of patent rights under the Korea–U.S. Tax Treaty, held that royalties for patents not registered in Korea were not subject to taxation in Korea. The Korean tax authority, however, appealed to the Supreme Court, arguing that the royalties constituted Korean-source income

Issue

Whether royalties for patents not registered in Korea can nonetheless be treated as Korean-source income and subject to tax if the patented technology is substantially used in Korea.

Court Ruling and its significance

Historically, the Supreme Court had determined the taxability of patent royalties under the Korea–U.S. Tax Treaty based on the principle of territoriality—i.e., whether the patent was registered in Korea.

In this landmark ruling, however, the Court reversed its position and held that the decisive factor is whether the patented technology is substantially used in Korea (Supreme Court, September 18, 2025, 2021Du59908).

The Court clarified that:

- The meaning of "use" under the treaty must be interpreted in light of Korean domestic tax law.
- Under Article 93(8) of the former Corporate Income Tax Law, even unregistered patents are deemed to be "used in Korea" if they are utilized for manufacturing or sales in Korea.

- In this context, “use” does not refer to the legal exercise of patent rights, but to the practical use of the patented technology in Korea.

Change of Precedent

This ruling expressly overruled earlier decisions that had narrowly interpreted “use” of a patent under Articles 6(3) and 14(4) of the Korea–U.S. Tax Treaty to mean “working the patent only where it is registered.”

As a result, several prior rulings issued over the past 33 years have been overturned, including:

- Supreme Court, May 12, 1992, 91Nu6887
- Supreme Court, September 7, 2007, 2005 Du8641
- Supreme Court, November 27, 2014, 2012 Du18356
- Supreme Court, December 11, 2014, 2013 Du9670
- Supreme Court, December 27, 2018, 2016 Du42883
- Supreme Court, February 10, 2022, 2018 Du36592
- Supreme Court, February 10, 2022, 2019 Du50946
- Supreme Court, February 24, 2022, 2019 Du47100

Keynote

When a Korean company pays royalties to a foreign company for unregistered patents, such royalties may constitute Korean-source income if the patented technology is substantially used for manufacturing or sales in Korea. In this case, the royalties are subject to Korean withholding tax regardless of whether the relevant patents are registered in Korea.

The scope of royalty payments under the contract, the territories covered, and the method of calculating royalties will have a direct impact on the determination of Korean taxability. Careful review of contractual terms is therefore essential.

In particular, where a single contract covers multiple jurisdictions, a critical issue will be how to reasonably allocate the portion of royalties attributable to Korea. Companies are advised to assess potential risks in advance and, where appropriate, consider seeking expert advice to prepare appropriate countermeasures.

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Newly Issued Tax Interpretations

Court decision on tax treatment of software payments: income classification

Company B (“B” or “Company B”), a wholly owned Korean subsidiary of a U.S.-based company, entered into a distribution agreement with its U.S. parent to sell and lease Computer-Aided Engineering (“CAE”) software in Korea and to provide related maintenance and training services.

Between 2016 and 2021, B paid consideration for the acquisition of software to the parent, and classified the payments as royalty income under the Korea–U.S. tax treaty and withheld the applicable tax. Company B subsequently filed for a refund request, asserting that the payments constituted consideration for the purchase of commercial software and should be treated as business income and thus should not be subject to tax in Korea.

The tax authority rejected the refund request on the grounds that the software embodied advanced technology and know-how, thereby qualifying the payments as royalty income. The Tax Tribunal upheld the tax authority's position, prompting Company B to file a tax lawsuit.
The Suwon District Court held that the payments should be regarded as consideration for the purchase of software and therefore constituted business income, rather than royalties (Suwon District Court, 2023GuHap76700, 2025.07.10). The Court highlighted the following key factors:

- Company B did not receive any undisclosed source code or technical information from its U.S. parent company.
- Company B was not granted rights such as reproduction rights for the software, nor did it appear to reproduce the software on its own or adapt it to customize the software for individual customers' specific requests.
- The payments for the software were calculated based on a fixed unit price rather than on usage.

Keynote: This decision clarifies that payments for software are not automatically classified as royalties but must be analysed based on the substance of the transaction. The Court emphasized that factors such as access to source code, the degree of customization, and the pricing method are critical in distinguishing between royalties and business income.

Thus, in practice, taxpayers should ensure that software distribution agreements clearly differentiate between simple resale arrangements and transfers of technology or know-how, with such distinctions explicitly reflected in contractual terms.

Tax Tribunal rejected "market-penetration" adjustments and the practice of selecting comparables based on "five consecutive years of selection" in calculating arm's length price

Company C ("C" or "Company C") is a Korean distributor that imports finished vehicles and parts and distributes them to domestic dealers. Due to the cancellation of certification and suspension of sales of certain completed vehicles that sharply reduced its market share and generated operating losses in certain fiscal years, Company C received loss-compensation payments, cost reimbursements, and service fees from its parent company which are recorded as non-operating income in its books. It also paid late-payment charges to the parent company on overdue trade payables and booked them as non-operating expenses.

Company C applied the TNMM as its transfer pricing method and performed year-by-year adjustments by adding back SG&A exceeding (i) its own prior three-year average ratio, (ii) comparables' prior three-year average ratio, and (iii) pre-incident three-year average ratio as part of a "market-penetration strategy". It also added the loss-compensation amounts recorded as non-operating income to operating income.

The tax authority accepted the add-back of loss compensation but disallowed other SG&A adjustments, and re-selected comparables by limiting them to companies appearing in all five consecutive years, and treated late-payment charges as operating costs, issuing assessments accordingly.

The Tax Tribunal ruled that (1) the "market-penetration strategy" is a group-level initiative to maintain the sales network and that shifting such costs to the local distributor lacked support and conflicted with the group's TP policy. Accordingly, the taxpayer's year-by-year SG&A add-backs based on the market-penetration strategy were rejected as discretionary. (2) Also, the Tax Tribunal viewed that limiting comparables to those appearing in each of the five consecutive years does not comply with the year-by-year analysis principle and is not a reasonable enhancement of comparability. (3) Moreover, the Tax Tribunal also determined that late-payment charges on trade payables constitute part of the purchase price rather than interest on loan, so deducting them from operating income was appropriate.

Furthermore, the Tax Tribunal held that the taxpayer did not qualify for the under-reporting penalty relief under Article 17(1)3 of the Law for the Coordination of International Tax Affairs, as the local file and the applied TP method were not deemed to reflect a reasonable judgment (Josim2023Seo9158, 2025.04.09).

Keynote: According to this decision, for a market penetration strategy adjustment based on the OECD Transfer Pricing Guidelines to be accepted, it is necessary to identify both the party bearing the costs and the basis for such cost allocation. In addition to that, comparables must be selected through a reasonable, year-by-year process. It should also be noted that late payment charges on trade payables should be regarded as operating expenses rather than interest on borrowings and therefore may be deducted from operating income.

Sales volume or reasonable adjustments should be considered when selecting comparables to compute arm's length prices

Domestic Company D ("Company D") was established in Korea to manufacture and sell polypropylene products, which are sold to both third parties and foreign related parties.

The tax authority determined that Company D had supplied products to its foreign related parties at prices below the arm's length price. For this purpose, the tax authority applied the cost-plus method to calculate the arm's length price using the cost-plus markups of transactions between Company D and third parties as comparables, even though the sales volumes of the comparable third parties varied significantly.

The initial ruling held that it was unlawful for the tax authority to select comparables having significantly different sales volumes without making reasonable adjustments for differences that could affect the cost-plus markup (Seoul Administrative Court, June 20, 2024, 2022GuHap83335). The Seoul High Court reached the same conclusion (Seoul High Court, February 5, 2025, 2024Nu52610), and the Supreme Court dismissed the final appeal and thereby upholding the lower court's decision (Supreme Court, June 12, 2025, 2025Du33231).

Keynote: This decision made it clear that differences in factors such as sales volume, which may affect the selection of arm's length comparables, must be considered - or reasonable adjustment must be made. It is viewed that the case reaffirms the necessity of making such adjustments when selecting comparables in transfer pricing analyses.

The provisions of the new enforcement fine system for failure to submit information documents during a tax audit have now entered into force

As noted in the July 2025 edition of Korean Tax Brief, beginning with tax audits commencing on or after September 15, 2025, if a taxpayer fails to submit lawfully required books and records without a valid reason during the audit process, the head of the regional tax office may impose an enforcement fine.

The fine must be deliberated by the Enforcement Fine Review Committee, which is chaired by the regional tax office commissioner and composed of six members designated by the commissioner, at least four of whom must be external members. In addition, the head of the regional tax office may, taking into account the extent of efforts made to submit the requested documents and the reasons for non-submission, reduce or exempt the penalty payment by up to one-half upon deliberation by the Enforcement Fine Review Committee.

Upcoming Tax Reporting Reminder

- Submission obligation of transaction statements by foreign online platform service providers and payment gateway (“PG”) companies: to be submitted by October 15, 2025.
- 2025 3Q VAT Return and Payment Deadline: October 27, 2025

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