

# Transfer Pricing Country Summary

## South Korea

July 2018

## Legislation

### Existence of Transfer Pricing Laws/Guidelines

Enacted in 1996 immediately after the publication of the OECD Guidelines in 1995, the Law for the Coordination of the International Tax Affairs (LCITA), the transfer pricing regulation in Korea, was the first, stand-alone international tax and transfer pricing law in East Asia to embrace the OECD principles. Through a series of amendments since published, the law itself, along with its decrees and enforcement rules, provides extensive guidelines on general transfer pricing practices encompassing comparability analysis, selection and application of transfer pricing methods, cost sharing, set-off transactions, and dispute resolution measures (uni-, bi-, and multilateral APAs).

The LCITA underwent major revisions and improvements in 2006; one milestone of the 2006 revision is the inclusion of the substance-over-form principle whereby the tax authority has been authorized to deny the legal form of a transaction(s) if the transaction(s) is deemed to have been structured for the purpose of inappropriately soliciting treaty benefits or the benefits provided for by the LCITA. Article 4 of the LCITA prescribes the application of the arm's length principle between related parties.

According to the regulations and provisions of Presidential Enforcement Decree (PED) of the LCITA, related parties are deemed to document the transfer pricing method used to determine the arm's length price (or range), the computed arm's length price (or range) itself, and all cases supporting them for related party transactions.

In April 2015, South Korea's National Tax Service outlined its policy on advance pricing agreements (APA) in the form of frequently asked questions describing the documents that should be submitted, when an APA will be canceled or withdrawn and the relationship between APAs and audits.

In 2015 and 2016, South Korea's Parliament approved the legislation to implement the OECD Base Erosion and Profit Shifting (BEPS) recommendations into the LCITA. The recently amended rules require all Korean domestic corporations that engage cross-border related party transactions meeting a certain threshold to file a 3-tiered transfer pricing documentation, namely the Combined Report of International Transactions Information (CRITI), which is comprised of the (1) Master File, (2) Local File, and (3) Country-by-Country Report (CbCR) reflecting the guidance provided by the BEPS Action 13 final report. The details of the transfer pricing related documentation rule are as follows.

(1) Local File and (2) Master File Related Obligation: A domestic corporation that satisfies all of the following requirements should submit the Local File and Master File within 12 months from the end of the fiscal year; (i) the total amount of transactions with foreign related parties that exceeds KRW 5 billion during a taxable year and (ii) the sales of a taxable year that exceed KRW 100 billion.

(3) CbCR Related Obligation: In case where the amount of sales revenue on the consolidated financial statements of the ultimate parent company in the immediately preceding tax year exceeds the

threshold amount for submission of CbCR under the laws of the country where the ultimate parent company is located, a domestic corporation, which is a subsidiary of the ultimate parent company should (i) submit Notification of CbCR within 6 months from the end of the fiscal year or (ii) (for failure to submit Notification of CbCR) submit CbCR within 12 months from the end of the fiscal year. A Korean ultimate parent company with the sales revenue on the consolidated financial statement in the immediately preceding tax year exceeding KRW 1 trillion should submit the CbCR within 12 months from the end of the fiscal year.

## Definition of Related Party

The following circumstances are considered related party:

- a foreign company directly or indirectly owns 50% or more of the voting shares of a Korean company; or
- a Korean company directly or indirectly owns 50% or more of the voting shares of a foreign company; or
- a corporation (or an individual), which directly or indirectly owns 50% or more of the voting shares of a foreign company, directly or indirectly holds 50% or more of the voting shares of a Korean company; or
- One transaction party (e.g. Company A) substantially controls the business policy of the other transaction party (e.g. Company B) or vice versa and at the same time they share the same interest; or
- The same third party substantially controls the business policy of both Company A and Company B and at the same time both transaction parties share the same interest.

Indirect Ownership is computed as follow:

- If Company A owns a 50% stake or more in Company B, and B owns a certain percentage of shares in a third Company C, B's equity ratio in C would constitute the ratio of equity which A indirectly owns C;
- If Company A owns less than a 50% stake of Company B, and B owns a certain percentage of shares in a third company C, then A is considered to own C to the extent of the ratio computed by multiplying A's equity ratio in B by B's equity ratio in C.

## Transfer Pricing Scrutiny

There is always a high risk of transfer pricing scrutiny for any corporate taxpayer engaged in cross-border related party transactions. The following cases are highly likely to be targeted for transfer pricing audit:

- Management service fees and royalty payments;
- Companies that incur consistent losses while revenues and/or assets increase;

- Companies that operate in industries where tax evasion is wide-spread, such as pharmacy, technology and private equity;
- Transactions conducted with affiliates in tax havens; and
- Reductions in the amount of tax paid resulted from changes in transfer pricing policy.

Regular tax audits are conducted every 4 years for corporate taxpayers, and transfer pricing has frequently been the primary target for the past several years for both Korean and foreign multinational companies operating in Korea. Along with tax return disclosures, detailed information may be requested and reviewed by the tax authority in the context of either a desk or field audit.

### Exemption from documentation obligation

Preparation of documentation is not required in the case of:

- The transaction is the asset transfer without consideration (excluding transfer at a significant low consideration or exemption of liability);
- The transaction is involved with assets purchased without any form of yield or profit, the contribution received of such assets in kind, or bearing expenses for such assets;
- The Enforcement Decree of the Corporate Income Tax Law assigns certain capital transactions to transfer profit to the other shareholders;
- The transaction is covered by APA; and
- The transaction bears contributions by proxy.

### Transfer Pricing Penalties

In case of the transfer pricing related assessment by the Korean tax authorities, the penalty tax for underreporting of 10% is applied to the assessed tax amount (60% for fraudulent cross-border transactions), and the penalty tax for insincere payment of 10.95% per annum, which is calculated based on the interest rate specified in the Framework Act on National Taxes, is also applied.

On top of these penalties and taxes assessed, the residential surtax of 10% is also imposed.

No interest is charged on the penalties.

The penalty of KRW 30 million will be imposed for failure to comply with the complete submission of each of the Master file, Local file and CbCR by the due date, or for submission of the Master File, Local File and CbCR containing false information. Therefore, the total CRITI related penalties could be KRW 90 million.

In this case, if the taxpayers submitted to the tax authorities a Contemporaneous Transfer Pricing Documentation prepared in good-faith and reasonably, an underreporting penalty tax (10% penalty on additionally assessed income tax) may be waived. The penalty up to KRW 100 million may be imposed

for failure to provide transfer pricing related information within the due date (generally 60 days from the request) upon the Korean tax authorities' request.

## Advance Pricing Agreement (APA)

Unilateral, bilateral, and multilateral APAs are available as from 1 January 2001 and can be sought for a 3-5 year period. Rollbacks may be granted for both unilateral (3 years) and multilateral (5 years) APAs. Status reports should be submitted annually by the applicant once the APA has been granted. Based on the National Tax Service's APA Annual Report, unilateral APAs are concluded approximately within 2 years and bilateral APAs 3½ years.

A simplified APA program is available for small and medium-sized foreign companies with annual sales of KRW 50 billion.

No filing fee is charged on APA application.

## Documentation and Disclosure Requirements

### Tax Return Disclosures

Taxpayers are required to submit the following corporate tax return forms at the time of the tax return filing according to the LCITA:

- Summary of international transactions;
- Disclosure and justification of transfer pricing method; and
- Summary of income statements of overseas affiliates.

### Level of Documentation

#### **CRITI (BEPS related documentation)**

The contents of the CRITI, which are in line with the guidance provided in the BEPS Action 13 final report and also are specifically provided by the National Tax Service with the template, are summarized as follows:

Master File:

- I. Group's Organizational Structure: Group overview, Group legal ownership structure, and Group control structure;

- II. Group's Business Operation: Important business profit drivers, Description of top 5 goods or services and goods or services in the supply chain above 5% of total sales, and List of important service agreements between related parties within the group, etc.;
- III. Group's Intangible Assets: Group's overall strategy for the development, ownership, and use of intangible assets, List of intangible assets of the group, and List of important intercompany agreements for intangible assets including cost sharing agreement, main R&D service agreement, and license agreement, etc.;
- IV. Group's Intercompany Financial Activities: Description of the group's overall financing method, Description of the entity performing main financing function for the group, and Description of the group's transfer pricing policy related to the financing agreements of the group;
- V. Group's Financial and Tax Positions: Group's annual consolidated financial statements for the fiscal year and List and description of the group's unilateral APAs and other tax rulings related to the profit allocation among the countries.

#### Local File:

- I. Company Overview: Introduction of the company, Business structure and organization chart, and Personnel for management-related reporting, etc.;
- II. Description of Intercompany Transactions: Overview of overseas related parties, Legal ownership structure of cross-border related parties, Ownership structure, Description and reason of the material related transactions, Details of each type of related transaction and relationship among overseas related parties, Detailed comparability analysis and functional analysis of taxpayer and overseas related party related to the related party transaction, Indication of the most appropriate transfer pricing method related to the transaction type and reasons for the selection, and List and description of (internal or external) comparable uncontrolled transactions, etc.;
- III. Financial Information and Agreements: List of reports related to the financial information of the company, Copies of all material related party agreements executed by the company, and Table summarizing financial information applied in the transfer pricing method matches with the annual financial statement of the relevant fiscal year, etc.

#### Country by Country Reporting

- Table 1. Overview of allocation of income, taxes, and business activities by tax jurisdictions;
- Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction;
- Table 3. Other additional information.

## Contemporaneous Transfer Pricing Documentation

Other taxpayers engaged in cross-border related party transactions below the threshold for the BEPS related documentation are still required to maintain reasonable transfer pricing documentation (Contemporaneous Transfer Pricing Documentation) by the due date of filing the corporate tax return and to submit it within 30 days upon the Korean tax authorities' request.

Article 19(1) of the Enforcement Decree of the LCITA below provides a list of information or documents that are expected to be included in the Contemporaneous Transfer Pricing Documentation for the Korean tax authorities' request for submission.

1. Various relevant contract documents concerning the transfer or purchase of assets;
2. Price list of products;
3. Statement of manufacturing costs;
4. Specification of trades by item, distinguishing between the related parties and the unrelated parties;
5. Documents corresponding to subparagraphs 1 through 4, in the cases of the offer of services or other trades;
6. Organizational chart of a corporation and a table of division of office duties;
7. Data for determination of international trade prices;
8. Internal guidelines for pricing among the related parties;
9. Accounting standards and methods relating to the relevant trades;
10. Details of business activities of the parties involved in the relevant trades;
11. Current status of mutual investments with the specially-related parties;
12. Forms or items omitted at the time of returns on the corporate tax and income tax;
13. Materials with which it is possible to grasp the details of a transaction in connection with a service transaction under Article 6-2, as specified by Ordinance of the Ministry of Strategy and Finance;
14. Materials specified further by Ordinance of the Ministry of Strategy and Finance including an agreement on cost allotment in connection with the tax adjustment by the allotted arm's length cost under Article 6-2 of the Act; and
15. Other data necessary for computing proper prices.

## Record Keeping

There is no specific requirement for the record keeping period. In general, the statute of limitation of 5 years applies.

## Language for Documentation

The Local File is to be submitted in the Korean language only. The Master File may be submitted in English and/or Korean (provided that the Korean version is submitted within 1 month after the submission of English version). The CbCR is to be submitted in both the English and Korean languages.

## Small and Medium Sized Enterprises (SMEs)

A simplified APA program is available for small and medium-sized foreign companies with annual sales of KRW 50 billion.

## Deadline to Prepare Documentation

The due date for filing the Master File, Local File and CbCR is within 12 months from the parent company's fiscal year-end.

## Deadline to Submit Documentation

Upon the Korean tax authorities' request, transfer pricing related information must be submitted within 60 days, and a one-time extension of 60 days can be granted upon a taxpayer's request. In addition, upon the Korean tax authorities' request, the Contemporaneous Transfer Pricing Documentation must be submitted within 30 days.

## Statute Of Limitations

The statute of limitations for transfer pricing adjustments is generally 5 years from the day after the due date for filing the corporate tax return. This period is extended to 7 years if taxpayers submit tax return later than the deadline, to 10 years in case of fraud or wrongful acts, and to 15 years in case of cross-border fraud (applicable for taxable years starting on or after 1 January 2015).

## Transfer Pricing Methods

South Korea closely follows the 2010 OECD Transfer Pricing Guidelines for transfer pricing methods. In particular, the following methods are in use:

- Comparable uncontrolled price method;
- Resale price method;
- Cost plus method;
- Profit split method;
- Transactional net margin method;
- Other reasonable method.

The selection of transfer pricing method depends on facts and circumstances of the related party transactions, but the selection generally should be based on the most appropriate method.

## Comparables

The local database, namely the KIS-Line, which provides business and financial information of Korean companies, is available. If the tested party is located in Korea, there is a preference for Korean comparables using the KIS-Line. The Korean tax authorities may also accept foreign comparables, but in practice, this may be subject to aggressive scrutiny.