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The International Tax Bible - Transfer Pricing Case

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Position Paper on Transfer Pricing Issue

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I. Transfer Pricing Issues

In the course of conducting transfer pricing audit on OOO Korea Branch (hereinafter referred as “A”), the Korean tax authority asserted that A’s transfer price is not within the arm’s length range and suggested that transfer pricing adjustment should be made.

The Korean tax authority’s positions with respect to A’s intercompany transactions are as follows:

(i) As OOO Malaysia (hereinafter referred as “B”) and A constitute one legal entity, it would be reasonable to treat A as performing the same functions as B. A should therefore be regarded as a distributor.

(ii) Thus, the arm’s length nature of A’s transfer price should be examined based on the resale price method reflecting the gross profit of general distributors engaging in sales of similar products in Korea.

(iii) In determining the arm’s length profit attributable to “subsidiary” and “branch” in Korea, different standards should be applied to each entity since two entities have different characters from the legal perspective.

II. One Legal Entity Issue

The Korean tax authority asserts that A and B should be viewed as one legal entity for the purpose of determining A’s arm’s length profit regardless of A’s actual function and risk burden in Korea, and thus A should be treated as a distributor.

Notwithstanding the fact that A and B perform separate functions under their respective tax jurisdiction (regardless of the substance of transaction), the Korean tax authority believes that A’s functions and risk burdens are identical to those of B since the two entities comprise a single entity from the legal perspective.

However, it is thought that the Korean tax authority’s proposed plan of tax assessment is unreasonable since its approach does not take into account the characteristics of real functions and risk burdens by A (sales support activities relating to B’s Korean sales).

Thus, the taxpayer explains his/her position concerning the Korean tax authority’s tax assessment plan in the following sections.

A. Head Office and Branch Offices in Korea

Let us assume that company “Y” establishes a head office in Seoul with branch offices in Pusan (branch A), Kwangju (branch B), and Daegu (branch C). The head office earns the profit of 200 and each branch office earns the profit of 50.

Under the Korean tax law, the head office and the branch offices are required to pay corporate tax to the Korean government. In doing so, Y should compute payable corporate tax by consolidating the profit of head office with the individual profits of the branch offices.

The Korean government can exercise its taxing rights over the whole income of Y since all four taxable entities comprising the company Y are located within the same tax jurisdiction (Korea). As such, the branches need not file separate corporate tax returns to the Korean government.

B. Branch Office in a Different Country

Again, let us assume that Y establishes one of its branch offices in Malaysia. In this case, the Malaysia branch office will be regarded as a separate taxable entity with its own tax payment obligation under Malaysia tax jurisdiction irrespective of whether it constitutes a single legal entity with the head office. Thus, for the tax purpose, the Malaysia branch office shall pay corporate taxes to the Malaysia government according to the Korea-Malaysia Tax Treaty and the domestic corporate tax law of Malaysia.

That is to say, if the company Y were to establish one of its branch offices in a country other than Korea (in this case, Malaysia), this branch office will be regarded as a taxable entity of the other tax jurisdiction (Malaysia) subject to the corporate tax laws of that country. Thus, depending on whether a branch office was located in Korea or a different country, its character as a taxable entity changes.

A branch located in a country different from the location of a head office is affected by the taxing rights of the country, and is liable to pay corporate income tax to the government having jurisdiction over the branch based on the appropriate amount of income corresponding to its functions and risks according to international tax principles.

Considering the above, if the Korean tax authority attempts to make unreasonable tax assessment on A based on the argument that a head office and a branch office should be viewed as a single legal entity without having regard to the functions and risks of each entity, the Korean tax authority's approach would lead to an unreasonable result in terms of the international taxation norm.

As an example to clarify our position, assume the following:

A head office in Malaysia has 400 employees who engage in business activities related to Korea sales and a branch office has 40 employees in Korea to support Malaysia head office's sales activities in Korea. The head office and the branch office realize KRW 100 billion of sales revenue in Korea by selling their group products in Korea.

The tax assessment plan shows that the Korean tax authority didn't take into account the specific functions and relevant expenses of the head office (with its 400 employees) with regard to Korea sales. Where the Korean tax authority asserts that the head office and the branch office constitute one legal entity for tax purpose and the gross margins of comparable companies should be applied to the KRW 100 billion of sales revenue to compute income attributable to the branch office, taxpayer will face a highly unreasonable result because only Korean government will exercise its taxing rights on the company's business operations.[1]

Thus, although the head office and the branch office comprise single entity from the legal perspective, two offices should be regarded as independent entities for the purpose of allocating the income attributable to the Malaysia and Korean governments with respect to the concerned business transactions.

In terms of international taxation norm, therefore, it would be reasonable to determine the appropriate amount of income attributable to each taxable entity based on their respective functions and risks burdens related to sales transactions in Korea.

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[1] Assume that gross margin of 10% is the appropriate margin in relation to the sales revenue of KRW 100 billion. If the Korean tax authority asserts that the gross margin of 10% is the profit to be realized by the branch office in relation to Korea sales, the implication would be that Malaysia head office realized no profit in relation to Korea sales, which is very illogical from Malaysia head office's standpoint.

C. Korea-Malaysia Tax Treaty and International Taxation Standards

It is considered that a fundamental issue with respect to the current tax assessment plan is whether the head office and the branch office should be regarded as one legal entity or separate independent entities to determine the correct amount of income attributable to A and B.

For this purpose, it would be appropriate to examine relevant provisions under Korea-Malaysia Tax Treaty as the tax treaty has priority over domestic laws of relevant tax jurisdictions.

[Related Provisions under Korea-Malaysia Tax Treaty]

- **<u>Paragraph 1, Article 7:</u>**

"If the enterprise carries on business [in the other State] as aforesaid [through permanent establishment], <u>the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment"</u>.

- **<u>Paragraph 2, Article 7:</u>**

*"...there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make **<u>if it were a distinct and separate enterprise</u>** engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

Although a head office and a branch office constitute one entity, the above rules provide that the income attributable to A (permanent establishment) may be taxed by the Korean government by (1) attributing only so much profit as is attributable to the permanent establishment, and (2) determining the profit which the permanent establishment might be expected to make had it been a distinct and separate enterprise dealing wholly independently with the entity of which it is a permanent establishment.

Thus, the Korean tax authority's assertion that A should be regarded as a distributor (like the head office) would lead to an unreasonable result since it would imply that almost all profits generated through sales in Korea should be attributed to A. Further, this method of tax assessment would be in a direct violation of the Korea-Malaysia Tax Treaty, which should be well respected by the Korean government.

Moreover, the OECD Transfer Pricing Guidelines emphasizes that income attributable to each taxable entity should be determined in consideration of functions and risk burdens of each entity. Since A performs functions at much less scope than routine distributors, a tax assessment based on characterization of A as a routine distributor would directly violate not only the Korea-Malaysia Tax Treaty but also international taxation norm, and the Korean government would face fierce challenges by the Malaysia government.

III. Branch vs. Subsidiary

The Korean tax authority contends that a branch and a subsidiary should be differently treated in determining the income attributable to them from transfer pricing perspective. In determining the appropriate income attributable to a **subsidiary,** its functions and risks are the principal factors to be considered. On the other hand, such factors need not be considered in determining the appropriate income attributable to a **branch office** since the branch and its head office constitute one legal entity. As such, the appropriate income to be attributed to a branch office should be determined by treating the branch office as performing the same functions as the head office.

In the earlier sections of this paper, the unreasonableness of treating the branch office and its head office as one legal entity for the income adjustment purpose in relation to international transactions was explained in detail.

In this section, it is observed whether or not there exists a difference between a subsidiary and a branch in calculating the appropriate amount of income attributable to each entity.

[Related Provisions]

- **Article 7, Paragraph 1 of Korea-Malaysia Tax Treaty:**

"If the enterprise carries on business [in the other State] as aforesaid [through permanent establishment], the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment".

- **Article 7, Paragraph 2 of the Tax Treaty:**

"…there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make ***if it were a distinct and separate enterprise*** *engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

- **Article 7, Paragraph 3 of the Tax Treaty:**

In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

- **Article 9 of the Tax Treaty:**

"…conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from ***those which would be made between independent enterprises****, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*

- **OECD Transfer Pricing Guideline VII.**

If the intra-group services have in fact been provided to a subsidiary, and if the intra-group charge for such services is in accordance with the arm's length principle, the expense should be allowed as deductible expense for tax purpose.

According to Article 7 of the Korea-Malaysia Tax Treaty, the appropriate amount of income to be attributed to a **branch** shall be determined by "*attributing to that permanent establishment the profits* ***which it might be expected to make if it were a***

__distinct and separate enterprise__ *… dealing wholly independently with the enterprise of which it is a permanent establishment."*

In addition, Article 9 of the Tax Treaty stipulates that the appropriate amount of income to be attributed to a **subsidiary** shall be determined by *"including in the profits of that enterprise any profit which would have accrued to that enterprise, but by reason of conditions differing from* ***__those which would be made between independent enterprises__****, have not so accrued."*

Accordingly, the Tax Treaty does not differentiate a subsidiary from a branch in determining the appropriate taxable profit for each entity.

Moreover, in relation to expense allocation among a head office and its branches offices, Article 7 Paragraph 3 of the Tax Treaty states "*In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere."*

OECD Transfer Pricing Guidelines Chapter VII also allows intra-group service charge among subsidiaries and related parties if the services relate to business operations.

As can be seen above, Korea-Malaysia Tax Treaty and OECD Guidelines do not place distinction in calculating the appropriate amount of profit attributable to a branch and a subsidiary.

Although there is Basic Ruling 92-129…2 of the Korean Corporate Tax Law [Calculation of interest payment resulting from loan transaction between the head office and a branch office of foreign bank] which regulates, "Interest paid in relation to fund received by a Korean branch office of a foreign bank from its overseas head office is not deductible while its interest payment against fund from a third party is allowed as deductible expenses", this ruling does not apply to A (a sales support service provider) since the above Ruling concerns the calculation of corporate tax in relation to loan transactions only between a head office and a branch office of a foreign bank.

As already explained in numerous occasions, neither the Korean tax law nor the Korea-Malaysia Tax Treaty places distinction in determining the appropriate amount of profit attributable to a subsidiary and a branch.

Thus, regardless of the legal form of the entity in Korea (a subsidiary or a branch), the entity will be responsible for reporting to the Korean government an income corresponding to its functions and risks incurred in relation to its business operation in Korea.

For example, let us assume that B's parent company instead decided to establish a Korean subsidiary (which is a service provider) with the identical or substantially same functions and risks as A which is a service provider (not buy/seller).

The Korean tax authority would assert that the subsidiary should report its income to the Korean government based on its functions and risks as a service provider in Korea whereas a branch should report a higher level of income as a buy/seller despite the same functions and risks as the subsidiary.

Therefore, if the Korean tax authority continues to emphasize that a subsidiary and a branch should be differentiated based on a mere form rather than focusing on the actual functions and risks undertaken, a branch would have to report to the Korean government a higher level of profit than a subsidiary although it performs the same functions and bears the same risks as a subsidiary, and it will result in extremely unreasonable consequence.

IV. Group TP Policy

The Korean tax authority asserts that the appropriate profit to be attributed to A should be determined by applying the Resale Price Method using Korean general distributors as comparables since the facts indicate that the transfer price between A and B is being determined on the basis of gross margin of overseas comparables (Group TP policy).

However, the Korean tax authority's assertion could result in a flawed conclusion that the Group's transfer pricing policy has a priority over Korean domestic tax law (the Law for Coordination of International Tax Affairs) or OECD Transfer Pricing Guidelines where Group's transfer pricing policy would not produce arm's length price from the Korean tax perspective.

In fact, the Law for Coordination of International Tax Affairs ("LCITA"), Article 5, paragraph 1 (Method of Computing Arm's Length Price) provides "… *factors such as the function of business activity, contract conditions, risks accompanied by transactions, the kind and characteristics of goods or services, changes in market circumstances, and economic circumstances which could affect a price or profit should be analyzed.*"

OECD Transfer Pricing Guideline also provides that the arm's length price should be calculated considering a function of the concerned resident, the degree of risks and economic circumstances.

Accordingly, even though transfer price of A is determined by applying Resale Price Method pursuant to the Group policy, the Korean tax authority should nevertheless examine whether the appropriate amount of income was attributed to A taking into account its functions and risks in accordance with the LCITA.

If the Group determines the transfer price between its overseas related parties on the basis of Berry ratio, would the Korean tax authority accept the results as is? Probably not.

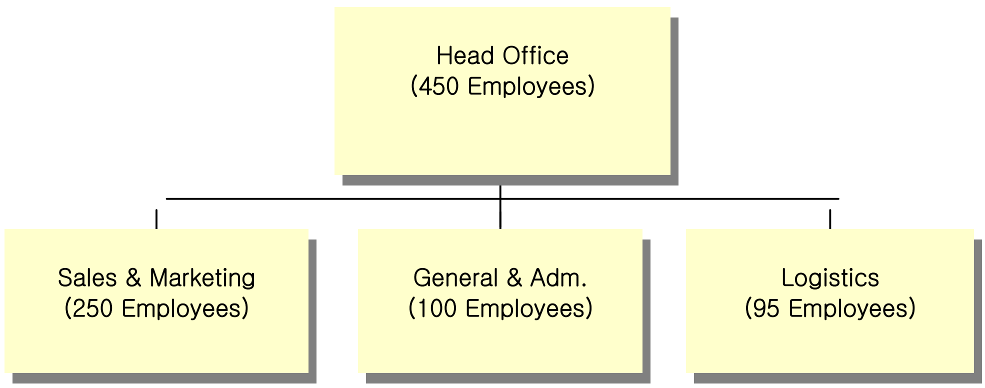
This is because regardless of which transfer pricing method is used to determine the Group's transfer pricing policy, the Korean tax authority would use its own approach to calculate A's arm's length income corresponding to its function performed and risk assumed.

The previously submitted transfer pricing report concluded that the best method to evaluate the arm's length price of A is the Transactional Net Margin Method (operating margin) after analyzing various economic factors stipulated under Article 5, Paragraph 1 of the LCITA – business functions, contractual terms, risks accompanying the transactions, kinds and characteristics of goods or services, changes in market circumstances, and economic circumstances. Thus, the study result of this TP report should be treated as reasonable unless the Korean tax authority have rebuttal opinion upon it.

V. Business Overview of Branch Office (A) and Head Office (B)

The purpose of this section is to provide an explanation of overall activities performed by A and B and examine the degree of intervention exercised by A and B, respectively, when a contract is concluded with clients in Korea.

A. B's business activities



The Sales and Marketing Department of B, which is comprised of 250 employees, is in charge of such activities as sales and marketing, Asian region sales promotion, sales maintenance, and etc.

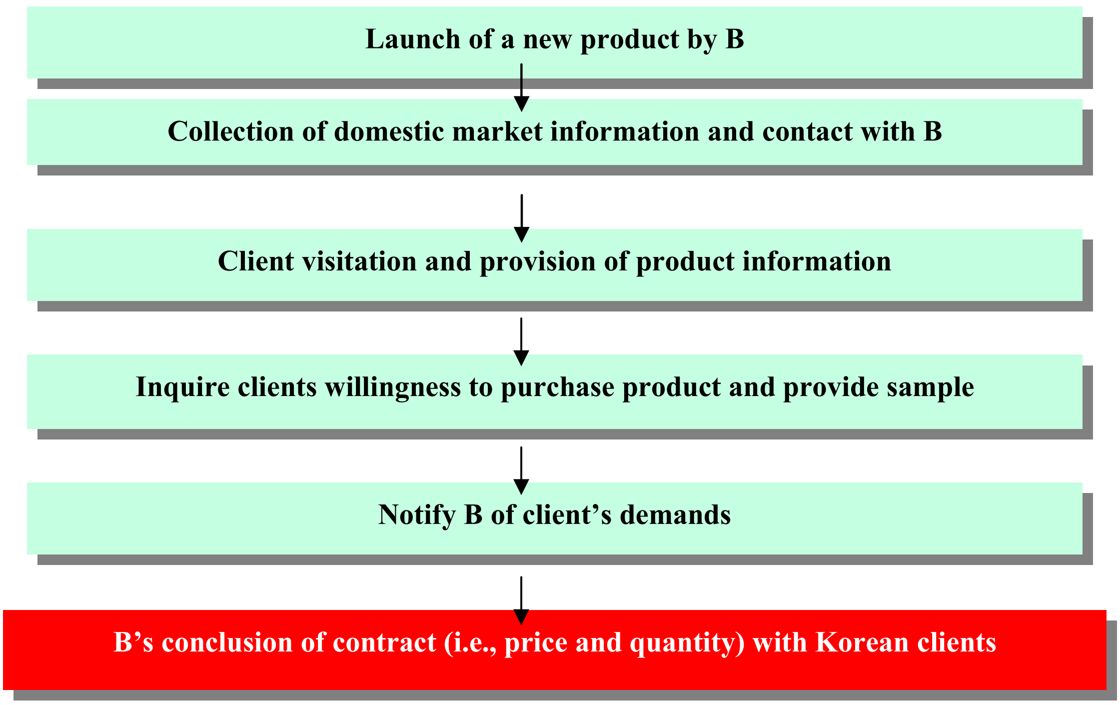
The General and Administration Department employs 100 personnels and performs activities including financial and administrative management, purchasing, information management service, general administration, and personnel management. The department's duties also include providing maintenance support and services for sales activities in the Asian-Pacific region. Moreover, the General and Administration Department controls and manages A's sales revenue, COGS, account receivable, account payable, collection of account receivable, and etc.

The 95 employees of the Logistics Department are responsible for the shipment and safekeeping of all products sold in the Asian-Pacific region.

The Korean tax authority has taken the position that because A performs a majority of marketing activities in Korea, most of income earned from sales in Korea should be attributed to A.

However, as described above, functions performed by B are essential to sales activities in Asia, including Korea, as these activities are performed in close relation with the sales activities of each affiliate. What is more, it should be noted that most of substantial activities related to Korean sales are performed by B. Therefore, it is difficult that the Korean tax authority has any logical basis for its position.

B. A's business activities



As depicted in the diagram above, the most important factors in product sales such as price agreement and quantity are determined between B and the Korean client.

In practice, a contract between B and Korean clients is concluded or renewed once every year or twice a year, after both parties have reached an agreement on the crucial components of the sales contract such as quantity, price, method of payment, shipment method and other terms.

The role of A's sales employee is solely restricted to receiving product information from B and conveying that information to Korean clients. In addition, when a client, upon taking into consideration the conditions of domestic market and the level of competitiveness, makes a request for modifications in the price and/or the conditions of sales, A's sales employee will obtain information related to the client's demand and sent that information to B.

Hence, A's marketing functions - activities subject to scrutiny by the Korean tax authority - are essentially related to assisting B and Korean clients in reaching a contractual agreement, and A is compensated for the performance of its activities.

Had there existed no branch (A) in Korea, it would have been possible for B to request a third party to perform the same functions as A. In this case, any reasonable third party would have accepted the offer if it were remunerated at the same level of compensation as A. Therefore, there would be no logical justification to argue that A's profit related to intercompany transactions with B falls below the arm's length price.

VI. Transaction Parties

In this section, explanation on the transaction parties is provided. As clearly shown in the sales contract between B and Korean customers, the contracting parties of sales contract are B ("Seller") and a Korean customer ("Buyer"). Also, the important elements of the sales contract including the price and the sales conditions are agreed upon by B and the Korean customers.

Therefore, if Korean customers notify A of the purchase order based on the contract with B showing appropriate sales price and sales conditions for their semi-annual demand, A inputs the purchase order in a computer ordering system and then informs the customers of specific details in regards to shipping and freight.

As said earlier, specific elements covered under sales agreements are negotiated between B and Korean customers while A merely functions as a contact point between the parties. This fact substantiates that the actual sales transactions occur between B and Korean customers.

VII. Risk Analysis

A. Credit Risk

The Korean tax authority's position concerning the credit risk is as follows:

- Activities related to collection on account receivable are not actively performed by B. When a problem arises during the collection process, A's sales employee makes client visitation to resolve the related matters.
- Since bad debt expenses are recorded in A's income statement, it is clear that A assumes credit and other related risks.

Taxpayer Position:

As explained above, the Korean tax authority has taken the position that A assumes credit and other related risks based on the fact that B does not actively participate in the payment collection process and that A's sales employees make client visitations when problems related to the collection process arise.

A has merely recorded accounts receivable in its book due to the following reason. During the 1995 tax audit, the Korean tax authority suggested that A should record accounts receivable on its book to reduce the risks that it may be deemed a permanent establishment of B. Since then, A has continued to record account receivables related to B's sales in Korea on its book. However, A records account receivables in its book merely in form but such an accounting treatment does not reflect the economic substance of the transaction.

The substantive creditor/debtor relationship exists between B and Korean customers. Hence, in the event an indebted customer incurs a problem in paying off its debt, the ultimate collection responsibility lies with B. Therefore, although A records account receivables in its accounting book, it does not change the fact pattern that B, an actual transaction party involved in sales transactions with Korean customers, bears the credit risk and other related risks.

However, A acknowledges that the recognition of the bad debt expense on A's income statement has resulted in a reduction to the income attributable to A. Thus, there can arise potential tax disputes regarding the deductibility of the expense from the Korean corporate tax perspective.

However, it should be emphasized once again that although A recorded account receivables and bad debt expense in its income statement, such an accounting treatment cannot change the substance of transaction itself from a transfer pricing perspective. That is, an actual party which bears the collection risk related to account receivables is B not A. Accordingly, the Korean tax authority's assertion that A assumes credit and related risks has no reasonable justification.

B. Inventory Risk/Quality Control Risk

- As one legal entity, A and B have joint ownership of inventory assets and therefore, A bears inventory risks;

- The losses on the inventory disposal and devaluation are assumed by A;

- Sales returns are directly deducted from the sales revenue recorded in A's P/L statements.

Taxpayer Position:

The Korean Tax Authority's assertion regarding one legal entity cannot change the substance of transactions concerned. The computation of income attributable to the Korean government should be based on a substance other than a form in terms of transfer pricing. Thus, taxpayer doesn't agree with the Korean Tax Authority's assertion that A bears inventory risk in terms of transfer pricing.

The Korean Tax Authority's contention that A substantially bears losses on the inventory disposal and devaluation is not established by actual facts. Thus, where the Korean Tax Authority makes its tax assessment based on a simple assumption but not substance, it will lead to an unreasonable result.

It is judged that the accrual of sales returns on A's books has affected the income to be attributed to A. However, the deductibility of such expense for tax purpose is a separate issue from transfer pricing.

C. Foreign Exchange Risks

The Korean Tax Authority holds the following position in relation to the foreign exchange risks.

- The fact that the foreign exchange gain or loss are recorded in A's income statement indicates that A assumes all foreign exchange risks

Taxpayer Position:

As with account receivables and inventory, the fact that A is recognizing foreign exchange gain or loss in its book does not reflect the true economic substance of its activities. As explained before, A has recorded foreign exchange gain in its book in order to avoid the risk of PE taxation by the Korean government.

Thus, from the transfer pricing standpoint, the Korean Tax Authority's assertion that A assumes foreign exchange risks is not reasonable.

For the fiscal years 1997 through 2001, A paid the Korean government corporate taxes related to the net foreign exchange gain of KRW 6,729,526,000, which is against an economic substance.

Therefore, if the Korean Tax Authority has to raise issues in regards to the bad debt expense and sales return, it would be appropriate to deduct these from the foreign exchange gain reported by A.