

Introduction to the Proposed Underreporting Penalty Relief through the Preparation of Contemporaneous Transfer Pricing Documentation

On September 1, 2008, the Ministry of Strategy and Finance (“MOSF”) announced various proposed amendments to the tax laws which include provisions to provide penalty relief to taxpayers maintaining contemporaneous transfer pricing documentation.

Currently, a transfer pricing adjustment will generally result in additional corporate tax of 25%, an underreporting penalty of 10% of the additional corporate tax, and an underpayment penalty of 10.95% per annum. The additional tax and penalties will also be subject to a 10% resident surtax and if the amount of the transfer pricing adjustment is not repatriated back to Korea, it will also be subject to a secondary adjustment which generally treats the amount of the transfer pricing adjustment as a deemed dividend depending on the contracting party. The proposed amendment provides relief on the underreporting penalty of 10% if the taxpayer maintains contemporaneous transfer pricing documentation.

Prior to this proposed amendment, taxpayers were granted penalty relief if the taxpayer has demonstrated the arm’s length nature of its transfer prices through the mutual agreement procedures (“MAP”) or an advance pricing agreement (“APA”). These conditions are prescribed under Article 13 of the Law for the Coordination of International Tax Affairs (“LCITA”) and Article 23(1) of the Presidential Enforcement Decree (“LCITA-PED”) of the LCITA. Specifically, the underreporting penalty may be waived if:

1. The taxpayer provided the documents showing the selection procedure of the most reasonable transfer pricing method to determine the arm’s length price at the time of filing of the corporate income tax return;
2. The taxpayer in fact applied the selected transfer pricing method; and
3. The taxpayer prepared and maintained documentation regarding the above.

The proposed amendment provides relief on underreporting penalty even in cases where the taxpayers have not gone through MAP or APA procedures as long as transfer pricing documentation is maintained contemporaneously.

Proposed Amendment

Article 13 of the LCITA [Exception to Penalty Application]

The following provision is anticipated to be included to Article 13 of the LCITA:

In case where the taxpayer (1) prepares and maintains documentation, as stipulated in the relevant LCITA-PED, on the transfer pricing method declared on its corporate income tax return and (2) that such method was reasonably selected and applied..

Assuming that the proposed amendments are ratified by the General Assembly, the penalty waiver provision will be effective on transfer pricing adjustments occurring on or after January 1, 2009.

Further clarifications on the required documentation and the appropriateness in the selection of the transfer pricing method will be included in the relevant LCITA-PED to be released following the amendment to the LCITA. However, the following is anticipated to be included as required documentation: company overview, intercompany transactions with foreign affiliates, functional analysis, industry analysis, process of selecting the transfer pricing method and reasons for eliminating methods that were not selected. The LCITA-PED will also provide the due date in the preparation of the contemporaneous documentation.

Insights

The new documentation requirements and the resulting underreporting penalty relief provision are anticipated to affect Korean taxpayers as follows:

- ① Domestic companies engaged in related party transactions with foreign affiliates
 - In addition to providing penalty relief, requiring the Korean parent to maintain documentation provides an opportunity to re-assess its global transfer pricing positions and identify potential risks areas. In other words, by looking at transactions from both sides of the transactions (as opposed to single-sided analysis has historically undertaken by many Korean companies), Korean parent companies would be able to assess overall transfer pricing risks and quite possibly, improvement areas.
 - Documentation efforts by Korean parent will inevitably lead to reduced costs. More

and more territories are requiring local transfer pricing documentation, and the preparation of transfer pricing documentation by the Korean parent will enable global affiliates to leverage from such efforts, streamline the documentation process, and maintain consistency.

② Foreign-invested companies or foreign companies

- For foreign-invested companies or foreign companies, transfer pricing has always been one of the main areas of investigation during a tax audit. By complying with the new transfer pricing documentation requirements under the proposed amendments to the LCITA, companies should be able to reduce the risk of assessment and if assessed, minimize the amount through the underreporting penalty relief.
- If available, transfer pricing documentation prepared by overseas parent/headquarters may be leveraged in the preparation of the transfer pricing documentation, saving costs and burden.

The benefits of maintaining transfer pricing documentation goes beyond penalty protection. Carefully planned and executed documentation reduces transfer pricing challenges and assessments.

Samil PricewaterhouseCoopers has been actively involved in the drafting of the new documentation requirements whereby representing the voice of taxpayers. With any new developments, we will inform promptly along with our professional advice to help you manage your transfer pricing risks. If you have any questions related to the above, the following transfer pricing experts of Samil PricewaterhouseCoopers will be more than happy to answer your questions.

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