MOORE

EUROPEAN

# TRANSFER PRICING BRIEF

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## CONTENTS



## INTRODUCTION

**It seems today as if the whole world is dominated by the COVID-19 pandemic. In their battle against the virus, governments are spending huge amounts of money on health care, in supporting their people and trying to relaunch the local economy. We can expect that in the near future, the same authorities will look for new revenues to offset these expenditures: more than ever, they will compete for a fair share of national income tax on the worldwide profits of multinational enterprises (MNEs).**

This international tendency towards protectionism was already visible before the 'Corona age' in the BEPS discussion on digital taxation. Instead of embracing the global solutions proposed by the OECD, countries, France and the United Kingdom for example, took the initiative on their own to levy their own taxes on digitalisation for MNEs. The same holds good in the field of transfer pricing, which is the ultimate instrument MNEs use to shift profits and to reduce their global tax base. Countries have been developing new legislation to keep the tax base within their own jurisdictions.

In this second issue of TP Brief, we give you an overview of recent developments in Belgium, Italy and South Korea. We hope that these contributions can help your company to find its way across the complex transfer-pricing arena.

Happy reading and stay safe.


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# BELGIUM

## RECENT DEVELOPMENTS IN THE BELGIAN TRANSFER-PRICING LANDSCAPE

**It has not gone unnoticed that the EU Anti-Avoidance Directive (ATAD) and the OECD's Base Erosion and Profit Shifting initiative (BEPS) are having a considerable impact on Belgium's domestic and international business relations. Multinational groups will have to consider the far-reaching impact of the implementation of ATAD and BEPS rules into Belgian tax law. As Belgium has been a pioneer of these new international tax rules, we are awaiting clarification of the practical implementation as a good deal of tax legislation has been enacted and brought into effect within a short timeframe. Here, we are going to describe the most important changes that have taken place in the Belgian international tax landscape with an impact on transfer pricing.**

### Transfer-pricing documentation rules

Since 2016, Belgian permanent establishments and Belgian companies that are part of a multinational group have been required to file a Local File and Master File where any one of the following thresholds is exceeded:

- Aggregate of operating and financial income (excluding non-recurring income) of EUR 50 million
- Balance-sheet total of EUR 1000 million
- Annual average number of employees 100 full-time equivalents

These thresholds should be assessed on a standalone basis, based on the financial statements of the Belgian entity for the year immediately preceding the last closed financial year.

The Local File consists of a general part, A, which gives an overview of the company, its structure, (international) reporting flows, competitors, restructuring, information about its permanent establishments etc, while part B is more focused on cross-border inter-company transactions.

The Local File should be filed within the deadline for the corporate tax return via a specific application provided by the government.

The Master File consists of the components suggested in the BEPS Action 13 report. The Belgian authorities generally accept that the Master File may be prepared in line with OECD guidelines. Contrary to the Local File, the Master File must be filed within 12 months of the close of the group's reporting period.

The Country by Country (CbC) reporting form has to be filed by the ultimate parent company if the group has a consolidated gross revenue exceeding EUR 750 million, assessed on the basis of the financial statements of the year immediately preceding the last closed financial year. The report must be filed within 12 months of the close of the group's reporting period.

Belgian entities that are part of a multinational group exceeding the EUR 750 million reporting threshold have to notify the authorities of the identity of the ultimate parent company responsible for filing the CbC report.

However, once companies have given notice in this way, with effect from 1 January 2020 they only need to do so again if there has been a change with respect to the previous reporting period.

We can conclude that the transfer-pricing documentation rules have not changed substantially and that the Belgian authorities in general follow OECD guidelines. Of course, the administrative simplification represented by the need to renew identification of the CbC reporting entity only if there is a change of entity is welcome.

As for the future we await the questionnaires to come from the Belgian tax authorities once their data-mining tool for transfer-pricing documentation is up and running. As for the transfer-pricing rules in general, a Circular Note was published in February 2020, detailing how Belgian tax authorities intend to interpret the OECD Guidelines (see below)

### Sanctions regarding transfer-pricing documentation rules

More than two years after Belgium's new transfer-pricing documentation rules were introduced, new legislation has been implemented to prevent and sanction non-filing. Since 19 July 2018, administrative fines may be imposed on taxpayers after they have been given notice. By way of example, a fine for the 3rd violation may only be imposed if the taxpayer has already been put on notice in respect of the 1st and 2nd violation. These fines may be imposed in respect of the Master File, the Local File and the CbC notice. Negligence in filing may result in transfer-pricing audits.

The scale of fines is as follows:

- 1st violation: EUR 0.00
- 2nd violation: EUR 1250.00
- 3rd violation: EUR 6250.00
- 4th violation: EUR 12 500.00

If the taxpayer has acted fraudulently or wilfully to evade payment of tax, the fine for the first violation is increased to EUR 12 500.00 and is EUR 25 000.00 for all subsequent violations. Obviously, the burden of proof of wilful or fraudulent conduct lies with the tax authorities.

### Mutual agreement procedure

Tax disputes are not pleasant and usually require a great effort from the taxpayer as well as from the tax consultant and the tax authorities. Tax disputes in Belgium may last for more than two years in a transfer-pricing context. In many cases a solution is difficult to reach, and the taxpayer is left facing greater costs than the amount initially in dispute. However, Belgium's ratification of the multilateral instrument (MLI) and its entry into force on 1 October 2019 may bring about changes to the way disputes are handled.

Belgium has been eager to implement articles of the MLI such as the correlative adjustment in relation to transfer-pricing adjustments, article 11 MLI and articles 18-26 MLI regarding arbitration. In this way, the taxpayer will have numerous avenues for actively pushing for a solution in a transfer-pricing dispute.

Belgian taxpayers have three years in which to file a complaint with the competent authorities after

receiving notice of an element that can lead to a dispute, e.g. a tax assessment. If the complaint is not accepted, taxpayers may appeal to the courts. If admissible, an Advisory Commission will be set up to decide on the admissibility of the complaint.

If the complaint is found to be admissible the mutual agreement procedure may be initiated. There is a strict deadline of two years to reach a solution, but there is a possibility to extend this by a further year.

If the dispute is not resolved within the deadline, the taxpayer may request that an Advisory Commission or Alternative Dispute Resolution Commission be set up within 50 days. Within 120 days thereafter, the Commission must be set up and it must issue an opinion within a period of six months. The competent authorities must then make a final decision on the matter within a further six months.

While judgment must be withheld on all these deadlines and formal requirements, the taxpayer does now have an additional means of pursuing tax disputes in addition to the existing methods such as double tax treaties and the Council Directive on Arbitration 90/435/EEG.

### Controlled Foreign Company

In compliance with the European Anti-Tax Avoidance Directive (ATAD), the Belgian transactional approach on the CFC rules will be applied as of assessment year 2020 in respect of financial years beginning on 1 January 2019 or later.

Foreign permanent establishments or foreign controlled companies that are set up as an artificial construction to gain a tax advantage fall within the scope of the CFC rules if they meet the control and taxation conditions. Where the CFC rules apply, non-distributed profits of the financial year will be included in the profits of the financial year of the controlling company.

For foreign permanent establishments, it is self-explanatory that the control condition is met. For foreign companies, control is established when the controlling company has:

- A direct or indirect participation of at least 50% in the equity
- A direct or indirect majority of the voting rights or
- The right to at least 50% of the profits

The taxation condition is met when the controlled foreign company or permanent establishment pays less than 50% of the tax it would have paid if it were taxed under Belgian income tax rules. This means that a Belgian tax-calculation exercise has to be made for every tax assessment of the CFC. If the actual tax paid is less than 12.5% (50% of the 25% tax rate) of the deemed Belgian tax, the taxation condition is met.

Whether the CFC has been established as an artificial tax-avoidance construct must be assessed based on the OECD Guidelines. Unlike the situation with transfer-pricing adjustments, the burden of proof lies with the taxpayer. Here the taxpayer will have to prove that effective decisions are made, risks assumed, and assets are deployed in or by the controlled foreign company. Substance is the most important element in this discussion.

The CFC tax rules exist without prejudice to the transfer-pricing adjustments under article 185(2) of the Belgian Income Tax Code where the burden of proof lies with the tax authorities. This gives the Belgian tax authorities an extra weapon to tax foreign companies with artificial profit shifts.

### The long-anticipated Circular Letter on transfer pricing

On 25 February 2020, the Belgian Tax Administration published a Circular Letter (Circular Letter 2020/C/35) on the Transfer-Pricing Guidelines (2017). It specifies the preferences, interpretations and positions of the Belgian tax administration regarding various transfer-pricing topics. In general, the Belgian tax authorities adhere to the principles laid out in the 2017 OECD Transfer-Pricing Guidelines. Following the discussions on when the Circular Letter would be applicable, the Belgian tax authorities have now stipulated that it is applicable solely to related-party transactions taking place on or after 1 January 2018. However, certain specific topics will only enter into force as from 1 January 2020. Although a Circular Letter is only binding on the tax authorities, taxpayers should review the transfer-pricing policy they currently have in place to avoid any major discussions.

We hope that this update will help you to consider your transfer-pricing strategies more clearly. In case you require further information, do not hesitate to contact the authors listed below.

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# ITALY

## TRANSFER PRICING IN ITALY: A GENERAL OVERVIEW

### Primary Legislation

**As Italy is one of the founding members of the OECD, which it joined in 1960, it is no surprise that its tax treaties, administrative policies and transfer-pricing policies are essentially modelled on the OECD Model Tax Convention and the OECD Transfer-Pricing Guidelines for Multinational Enterprises and Tax Administrations.**

In particular, the tax-treaty provisions dealing with transfer pricing are normally:

- Article 9, which defines the concepts of arm's length value and corresponding adjustments and
- Article 25, which introduces a mutual agreement procedure (MAP) between the competent authorities of the countries of residence of the taxpayers involved, aimed at eliminating economic double taxation arising from, among other matters, adjustments of profits between associated enterprises by one of the tax authorities of the countries involved.

Italy has quite a long tradition in dealing with transfer pricing (from now on, 'TP') issues, as it first introduced TP provisions in its law in 1980, entering into force on 1 January 1981.

These provisions are currently found in Article 110(7) of the TUIR (i.e. *Testo Unico Imposte sui Redditi* – the Unified Income Tax Code, DPR No 917 of 1986, which came into force on 1 January 1988), most recently amended by Decree No 50/2017.

According to the current version of the law, any transaction carried out by a resident corporate taxpayer (or the Italian permanent establishment of a foreign entity) with an associated non-resident party (including a foreign permanent establishment of the Italian resident company) has to be evaluated (for income tax purposes) on the basis of the conditions and the prices that independent parties would have agreed on dealing at arm's length and in comparable circumstances.

The scope of application of TP rules is wide, as it applies to all transactions (sales of goods and assets, provision of services, loans and licences of intangible assets), regardless of the accounting impact of the transaction. Similarly, the concept of 'related parties' has to be interpreted in its broader extension. Article 2 of the Ministerial Decree (from now on, 'MD') of 14 May 2018 defines a person as 'related' to the taxpayer if:

- the enterprise resident in the territory of Italy participates, directly or indirectly, in the management, control or capital of the other non-resident company or vice versa or
- the same person participates, directly or indirectly, in the management, control or capital of both companies.

The MD interprets the concept of 'participation in the

management, control or capital' quite widely, as it comprises not only the situation where a person or company owns, directly or indirectly, more than 50% of the capital of another company, but also where that person or company exercises a 'dominant influence' over the commercial or financial decisions of another company.

The provision always applies whenever the application of the arm's length principle results in an increase in taxable income. However, it also applies where such application results in a decrease in taxable income subject to the conditions laid down by Article 31-*quater* of Presidential Decree No 600/1973.

Before the entry into force of Decree No 50/2017 (amending Article 110(7) TUIR), that paragraph provided that any income earned by a resident corporate taxpayer deriving from transactions entered into with associated non-resident parties must be evaluated on the basis of the 'normal value' (a concept that is not far from the comparable uncontrolled price (CUP) of the OECD Guidelines). The definition of the 'normal value' of goods transferred or services rendered or received is provided by Article 9(3) TUIR, which provides that it is equal to the average price or consideration paid for goods or services of the same or similar kind, agreed in a free market and at the same level of commercialisation, at the time and place in which the goods or services were purchased or performed, or, in their absence, at the closest such time and place.

Its determination should be based, if possible, on the lists and tariffs maintained by the supplier of the goods or services and, if these are not available, on the market reports and lists of the Chambers of Commerce, or on professional tariffs[1].

The aim of the law, since its introduction, has been to avoid erosion of the taxable base and profit shifting from Italy to other jurisdictions by multinational enterprises by means of their transfer-pricing policies. It applies when taxable income is shifted either to a low-tax jurisdiction or to a high-tax jurisdiction.

The law applies to all corporate taxpayers, not-for-profit entities that are carrying on commercial activities and Italian permanent establishments of foreign entities. It applies regardless of the size of the enterprises, without any minimum threshold.

Even though the Italian Constitution states that the legislative power on certain specific matters is concurrent between the State and the Regions (or in some cases is attributed to the competence of the Regions only), income tax matters belong to the exclusive competence of the State. Thus, the only legislation in force dealing with transfer pricing, both primary and secondary, derives from the legislative power of the State. The local administrative authorities have no competence or power in this sphere.

Apart from the abovementioned Article 110(7) TUIR, there are other laws that regulate transfer pricing in Italy, namely:

- Article 1(6) of Legislative Decree No 471 of 1997, providing the application of the 'penalty protection régime' to the preparation of the 'proper' TP local documentation
- Articles 1(145) and 1(146) of the 2016 Stability Law (No 208/2015) introducing, for tax periods commencing after 31 December 2015, the country-by-country ('CbC') reporting obligations in compliance with the OECD's Base Erosion and Profit Shifting Action 13 Report
- Article 31 of Presidential Decree No 600 of 1973 (relating to Advance Pricing Agreements, or 'APAs') and
- Article 31-*quater* of Presidential Decree No 600 of 1973 (unilateral domestic procedure to remove double taxation).

Italy is also one of the EU's founding Member States, therefore it has adopted Convention 90/436/EEC on the elimination of double taxation in connection with transfer pricing (the Tax Arbitration Convention).

Article 31-*quater*, introduced in 2017, makes Italy more compliant with the OECD Model Convention and rules.

As all international tax experts will know, the OECD Model Convention provides in its Article 9(2) the concept of 'corresponding adjustments'.

Italy, historically, lodged a reservation to Article 9(2), by which Italy reserves the right to insert in its treaties a provision where it will make corresponding adjustments only in accordance with an agreement reached by following a mutual agreement procedure (MAP). The Italian law, until 2017, used to provide downwards corresponding adjustments only as a consequence of a MAP.

Thanks to the introduction of Article 31-*quater* of Presidential Decree No 600/1973, the Italian tax authorities may acknowledge corresponding downward transfer-pricing adjustments in Italy deriving from a transfer-pricing adjustment made by foreign tax authorities in three cases:

- Agreements reached between tax authorities under a mutual agreement procedure (MAP) activated under the applicable double taxation convention or under the EU's Tax Arbitration Convention)
- Investigations conducted within the framework of international cooperation activities whose results are shared among the participant states
- Requests filed with the Italian Tax Agency (see below).

## Secondary Legislation

The above laws are sometimes implemented by secondary legislation and regulations, such as:

- Regulation No 137654/2010 of the Director of the *Agenzia delle Entrate* (the Italian Tax Authority), which contains the rules regarding transfer-pricing documentation
- Regulation No 42295/2016 of the Director of the *Agenzia delle Entrate* setting out the implementing rules for the international tax ruling procedure under Article 31-*ter* of Presidential Decree 600/73
- The Decree of the Ministry of Economy and Finance of 23 February 2017 (Country-by-Country reporting requirements)
- The Decree of the Ministry of Economy and Finance of 14 May 2018, containing the guidelines for the application of the statutory provision regulating transfer pricing and
- Regulation No 108954/2018 of the Director of the *Agenzia delle Entrate* containing the terms and conditions for downward-adjustment requests (according to Article 31-*quater* of Presidential Decree No 600/1973).

As Regulation No 108954/2018 is quite recent, it is worth discussing in greater detail. It provides the list of materials[2] that the taxpayer must exhibit to the tax authorities and the general guidelines on how a taxpayer may request a downward adjustment to its taxable income as a transfer-pricing adjustment, compliant with the arm's length principle, in consequence of an assessment made by a foreign tax authority of a state with which Italy has an effective exchange of information agreement in force.

The request[3] may be filed with the Office for Advanced Rulings and International Disputes of the Italian Tax Agency by any resident corporate taxpayer or Italian permanent establishment of a foreign entity. Among other information, the taxpayer must select the preferred kind of instrument for international-dispute resolution.

The Tax Agency then examines the request and the attached documentation. If the request does not meet all the requirements, the Tax Agency communicates the shortcomings to the taxpayer, requesting amendments; this latter must then fulfil those requests within 30 days, otherwise the request is dismissed.

The Italian Tax Agency has 180 days within which to issue a decision approving or denying the request. In the case of approval, the taxpayer's taxable income is adjusted correspondingly. In the case of denial, the taxpayer's chosen instrument for dispute resolution is activated. In this last case, the corresponding downward adjustment or the elimination of double taxation may be obtained only by means of a mutual agreement procedure (MAP) under the applicable double taxation convention, or the Tax Arbitration Convention.

1). Article 9(4) TUIR provides for a detailed definition of 'normal value' in respect of certain financial assets:

- the normal value of shares, bonds and other securities listed on Italian or foreign regulated markets is determined on the basis of the arithmetical mean of the prices of the last month;
- the normal value of shares, quotas or other participations in entities other than listed shares is determined in proportion to the value of the net equity of the company or entity;
- the normal value of bonds and securities other than listed bonds and securities is determined comparatively to the normal value of securities with similar characteristics listed on Italian or foreign regulated markets or, if not available, on the basis of other elements that can be determined objectively.

2). The following documentation is sufficient to satisfy the requirements of Article 31-*quater*:

- a translated copy of the tax assessment issued by the foreign tax authorities containing the upward adjustment;
- factual and legal elements demonstrating that the upward adjustment complies with the arm's length principle;
- certification by the foreign tax authorities attesting that the transfer-pricing adjustment made is final.

3). The request must contain the:

- Corporate Taxpayer Identification details;
- A description of the request (i.e., the elimination of double taxation arising from a transfer-pricing assessment made by a foreign tax authority, which is final and compliant with the arm's length principle; if it is not yet final, the request must describe the status of the procedure in the foreign state and the circumstances under which the adjustment becomes final);
- selection of the instrument for international dispute resolution, such as the mutual agreement procedure (MAP) under an applicable double taxation convention, the Tax Arbitration Convention (90/436/EEC), or any other instrument provided by the Italian legal system.

## Tax Audits

Transfer pricing falls within the ordinary competence of the Italian tax authorities, therefore the power of inspection is attributed to two competent authorities:

- *The Agenzia delle Entrate* and
- *The Guardia di Finanza*, the Italian Tax Police, a military force.

It is important to emphasise that only the Tax Agency has the power to issue tax assessments.

There is no specific unit competent for transfer-pricing matters, except for advance pricing agreements (APAs), but normally each local office has its specialist teams. Both authorities have developed highly skilled and trained teams of inspectors.

The risk of a general tax audit in Italy is high and the risk of being audited specifically for transfer pricing is even higher for a company belonging to a multinational group.

In the last ten years, the Italian tax authorities have conducted a massive drive against tax evasion and tax avoidance. Transfer pricing is almost always subject to scrutiny by the tax authorities during their inspections, since the identification of the arm's length value of a controlled transaction is very subjective and easy to challenge. The likelihood that the taxpayer's chosen TP methodology will be challenged by the tax inspectors is high. Quite often, the inspectors reject not only the methodology adopted, but also the functional analysis, the benchmark studies and the comparables chosen.

Those circumstances make transfer pricing a sensitive area for all taxpayers, and prone to generating a number of tax litigation cases, although alternative dispute resolutions are quite common.

## Administrative Circular Letters

Apart from the statute and the secondary legislation, it is important to know that the Italian Tax Authorities have issued several circular letters where they illustrate and clarify their interpretation of the law and the regulations. It is important to underline that the Circular Letters are not binding either on the courts or on taxpayers.

The most comprehensive circular letter on transfer pricing is still No 32 of 1980. That document is officially still in force although it is based on the OECD's 1979 TP Guidelines and is therefore not fully in line with the 2017 Guidelines (in particular, with reference to intra-group service transactions).

Another significant Circular Letter is No 8/E/2010, as it provides the official clarification on the 'proper documentation' necessary in order to obtain the penalty protection provided under Article 1(6) of Legislative Decree No 471 of 1997.

## Compliance and Documentation

Information on intra-group transactions must be reported annually in the taxpayer's income tax return. A more detailed listing of all intra-group transactions has to be included in the annual financial statements. Further information is required in some sectors (e.g. the disclosure requirements applicable to banks, based on Article 89 of EC Directive 2013/26).

The TP documentation set (as described in the OECD TP Guidelines) is not compulsory in Italy except for taxpayers required to comply with CbC reporting obligations (see below).

However, it is advisable to prepare proper documentation related to TP, as it is almost always requested by the tax authorities in the event of a tax audit of a company (or a PE) belonging to a multinational group.

Moreover, Article 1(6) of Legislative Decree No 471 of 1997 provides the application of the 'penalty protection régime', i.e. the taxpayer will not be subject to penalties, even when the tax authorities increase its taxable base following a transfer-pricing audit, if the taxpayer:

- has prepared proper transfer-pricing documentation
- has informed the Italian Tax Agency of the existence of such documentation (by ticking a specific box in the yearly tax return) and
- provides the Agency with the TP package within 10 days of the corresponding request from the tax inspectors.

Italian transfer-pricing documentation is in line with the contents of the EU TPD Code of Conduct (2006/C176/01) and consists of

- the Master File, which contains information concerning the group and
- the Country File, which deals with the enterprise concerned.

The detailed information that must be provided in each document is listed in Regulation No 137654/2010 of the Director of the *Agenzia delle Entrate* (see above).

In accordance with OECD BEPS Action 13, the EU and then Italy have introduced a new reporting obligation on the biggest multinational groups (those with a consolidated turnover of at least EUR 750 million in the preceding fiscal year), in the form of Country-by-Country (CbC) Reporting.

Italy introduced CbC Reporting in the 2016 Budget Law. Filing and submitting CbC reports is mandatory where the criteria apply. In case of violation, a specific penalty, ranging between EUR 10 000 and EUR 50 000, has been introduced.

On 23 February 2017, the Ministry of Economy and Finance issued a decree implementing CbC Reporting, with effect from reporting period 2016.

A future article will include further details on transfer-pricing documentation, APAs, dispute resolution and TP case law.

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# SOUTH KOREA

## TRANSFER PRICING IN KOREA

### The transfer-pricing environment in Korea

**Korea's transfer-pricing régime was introduced and enacted in December 1995 and has since then undergone a series of amendments, which were mostly aligned with the recommendations of the OECD's Transfer-Pricing Guidelines. Korea's transfer-pricing regulations are contained in the Law for the Co-ordination of International Tax Affairs ('LCITA'), its Presidential Enforcement Decree ('PED') and Ministerial Regulations (collectively, 'Korean regulations').**

This article provides a summary of key transfer-pricing aspects that are especially relevant to foreign investor companies in Korea. These include an overview of the transfer-pricing documentation requirements, penalties for non-submission of information, special focus areas in tax audits, and considerations for 2020 documentation arising from the global economic impact of the current novel coronavirus ('COVID-19') outbreak.

### Documentation requirements

Taxpayers in Korea, including a domestic company or a foreign company's domestic place of business ('permanent establishment'), are required to submit the Master File and Local File to the Korean tax authorities (i.e. the National Tax Service, hereafter 'NTS') if they meet the following two conditions for the relevant tax year: (a) their annual revenue exceeds KRW 100 000 million (approx. USD 82 million or EUR 75 million); and (b) their total cross-border transactions with foreign related parties amount to more than KRW 50 000 million[1] . The filing due date for the Master File and the Local File is 12 months from the end of the relevant tax year.

Both reports must be submitted in the Korean language. While the Master File may initially be submitted in English, a Korean translation must follow within one month.

A Country-by-Country ('CbC') Report is prepared and submitted by the Korean ultimate parent of a multinational enterprise ('MNE') if the MNE's annual consolidated group revenue in the immediately preceding fiscal year exceeds KRW 1 million million (approximately equivalent to EUR 750 million). The Korean subsidiary of a foreign-based MNE group would be required to submit a CbC Report in Korea only if any of the following cases applies:

- the foreign ultimate parent's country of residence does not impose the requirement to file a CbC Report or
- the CbC Report cannot be automatically shared between Korea and the filing parent's jurisdiction due to the absence of an exchange-of-information agreement (e.g. Multilateral Competent Authority Agreement or bilateral exchange agreement).

The filing due date for the CbC Report is 12 months from the end of the relevant tax year.

Following recent amendments to the Korean regulations, all three reports (i.e. Master File, Local File, CbC Report) must be e-filed via the NTS's electronic filing system (i.e. AXIS portal). This new change in rule is effective for submissions after 10 February 2020.

### Local v. foreign comparables

The NTS does not in general accept foreign comparables where the tested party is the Korean entity. This is based on the reason that a domestic public information database (i.e. Kisline) is available, which provides comprehensive business and financial information on companies operating in Korea. This local database is commonly used by the NTS and tax practitioners in Korea for benchmarking purposes. However, if the tested party is the foreign entity and can be considered the less complex party to the transaction under review, the NTS will generally accept the use of foreign comparables.

The search process used to select the comparables including the reasons for elimination (quantitative and qualitative) should be transparent and clearly documented as comparables are commonly subject to thorough review and potential challenges by the NTS during a tax audit.

### Penalties for non-submission or false information

Taxpayers that do not submit information timely or provide false information relating to their cross-border transactions (e.g. master file and local file, 'Statement of International Transactions', other relevant information requested by the NTS[2] ) may be subject to a penalty depending on the type of information.

Failure to submit the master file, local file or CbC Report by the statutory due date will result in a penalty of KRW 30 million per each report. With respect to the Statement of International Transactions, which is commonly filed as part of the annual corporate tax return, the penalty is KRW 5 million per each foreign related party. Under the previous regulations, the maximum penalty could not exceed KRW 100 million. However, following a recent change to the relevant regulations, taxpayers that have been charged with a penalty for non-submission or false information and have still not provided or corrected the information may be subject to an additional penalty that can be accumulated every 30 days until the relevant information is provided to the NTS. This additional penalty is capped at KRW 200 million.

The new rule on the additional penalty is effective for tax years beginning after 31 December 2019.

1). In determining whether the total cross-border transaction amount exceeds the KRW 50 000 million threshold, the amounts for goods, services and loans (principal plus interest) are totalled.

2). Information requested by the NTS must be submitted within 60 days of the request. Taxpayers may request a one-time extension of up to 60 days where a valid reason exists.

### Waiver of under-reporting penalty for contemporaneous documentation

Taxpayers who maintain contemporaneous documentation (which means having transfer-pricing documentation in place at the time of filing the annual corporate tax return or having filed the local file within the statutory time frame) may be eligible for a waiver of the under-reporting penalty (i.e. 10% of the assessed corporate tax liability) in the event a transfer-pricing adjustment is made as a result of a tax audit. However, the law prescribes that the penalty waiver may only be granted if it is recognised that the documentation sufficiently supports that the transfer-pricing method was reasonably selected and applied. This means that purely maintaining contemporaneous documentation will not automatically grant the taxpayer a waiver of the penalty. Rather, taxpayers need to consider the quality and robustness of their documentation and that it reasonably and substantively supports their transfer-pricing arrangements in order to claim eligibility for penalty waiver. Where requested by the NTS, contemporaneous documentation must be submitted within 30 days of the date of request.

### Common red flags triggering a tax audit

Common issues that are the focus area of the NTS during a tax audit include but are not limited to:

- Intra-group service charges
- Licence fees (royalties)
- Recurring losses, low or significantly fluctuating profits
- Intangibles transferred (IP valuation)
- Permanent establishments

#### Intra-group service charges and royalty payments

Intra-group service charges (or so-called management service fees) and royalty payments made to foreign related parties have been a long-standing issue and continue to be a focus area of the NTS during examinations.

Taxpayers are often requested to provide substantial amounts of information and evidence that support the arm's length nature of such charges. During a tax audit, taxpayers are generally given only a limited amount of time to provide the requested information and often face practical difficulties with respect to the extent of details that can be obtained from their foreign headquarters. This may result in additional information requests and further challenges from the NTS.

#### Low profits or losses

Companies that report consistent losses or low or significantly fluctuating profits are in general challenged by the NTS and expected to provide detailed documentation that reasonably supports their transfer-pricing outcome. This especially applies to companies with limited-risk operations (e.g. limited-risk distributors, contract manufacturers, or routine service providers) that are generally remunerated with a relatively low but stable return. In real-life audit cases, it is often observed that the NTS scrutinises the comparables selected by the taxpayer, which in many cases results in challenges and intensive debates over the search process and appropriateness of the selected comparables. It is not uncommon for the NTS to conduct its own comparables search and to make an assessment based on its own search results if the taxpayer cannot reasonably support the comparables selected in its transfer-pricing documentation.

#### Intangibles transferred

An increased focus is also placed on intangibles. The recent changes to the Korean regulations include new provisions prescribing that the entity performing the functions relating to the development, enhancement, maintenance, protection, and exploitation ('DEMPE') of the intangible is to be appropriately compensated, regardless of legal-ownership status. In addition, transactions involving the transfer of intangibles must be supported by documentation that clearly explains the valuation analysis performed (e.g. based on the discounted cash-flow method) and substantiates the reasonableness of the assumptions used in the analysis. Hence, taxpayers engaged in intangible transactions can expect increased scrutiny and extensive information requests relating to intangible transactions.

#### Permanent establishments

Companies engaged in sales-agency activities and/or operating under a 'commissionaire' structure are expected to face increased scrutiny from the NTS with respect to the existence of a permanent establishment ('PE'), given the recent amendments to the Korean corporate income tax law which align with the recent recommendations of the OECD's BEPS Action 7 Final Report. The amended rules include provisions on the expanded scope of a dependent-agent PE, the restriction of specific-activity exemptions to activities of a preparatory or auxiliary character and the anti-fragmentation rule. In view of these recent developments, it has become even more important for taxpayers operating under a commissionaire model thoroughly to review their commissionaire arrangements and minimise any exposure to PE risk.

### Proactive management and being prepared are key to minimising risk of adjustment and penalties

Conducting a transfer-pricing analysis may consume substantial time and resources, which is why taxpayers sometimes take a 'wait and see' approach and start preparing only when the documentation statutory due date is nearing or in fact a tax audit is approaching.

Especially preparing documentation at the time of a tax audit can be very stressful as taxpayers are generally expected to provide information within a very short time frame. If not well prepared or altogether unprepared, taxpayers can face multiple extensive information requests from the NTS and possible suspensions of the tax audit (e.g. if more time is requested by the taxpayer to prepare information), consequently prolonging the entire audit period and impacting the company's ability to focus effectively on its day-to-day operations.

Therefore, proactively maintaining appropriate documentation will be key in order to be strategically prepared and to manage any questions and challenges from the NTS effectively.

#### Transfer-pricing considerations for 2020 documentation arising from the impact of COVID-19

In the light of the current COVID-19 outbreak, which is affecting many MNE businesses worldwide, taxpayers will need to consider conducting a careful and more detailed analysis of their 2020 documentation, specifically addressing any transfer-pricing implications arising from the impact of the coronavirus pandemic (e.g. reduced profits or losses). In preparing the 2020 documentation, key aspects to be considered could, amongst others, include: any change in the existing transfer-pricing policy (e.g. if a different transfer-pricing method is applied or if the target margin under the TNMM (transactional net-margin method) is set to a lower level) and reason for change; the validity of existing comparables and whether comparability adjustments are necessary to take account of the economic downturn, or whether a new search with revised screening criteria (e.g. including companies with consecutive operating losses etc.) would be necessary; the method and rationale for 'true-up' adjustments performed or not (in case of the latter, there should be clear reasons for why it was determined appropriate to perform no true-up adjustment at all or only partially). This would require including a clear and detailed analysis of risk control and who in the MNE group should assume losses, especially if incurred by limited-risk entities.

That being said, a simple 'mechanical' update of prior-year transfer-pricing documentation including simple argumentation that profit declines or losses in Korea were incurred as a result of the unique economic circumstances (that is COVID-19) will not suffice in reasonably supporting the taxpayer's transfer-pricing policy and outcome and will be subject to significant challenges by the NTS during a tax audit.

Therefore, taxpayers are recommended to consider such transfer-pricing implications described above and take appropriate action in a proactive manner. It would also be useful for taxpayers to maintain contemporaneous detailed records relating to the specific business impact and implications of COVID-19 from a transfer-pricing perspective in order to be able to prepare clear and robust documentation that reasonably substantiates and supports their transfer-pricing position for 2020 and the coming years if necessary.

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