

# **APA of Korea NTS**

**October 2012**

**National Tax Service**

## 1. What is an APA?

Advance Pricing Arrangement or Advance Pricing Agreement (APA) is an arrangement agreed between a taxpayer and the NTS on the application of transfer pricing methodology (TPM) in determining arm's length price in advance of future international transactions with foreign related parties.

Transfer pricing regime refers to a taxation system where tax authorities re-calculate taxable income based on arm's length price and impose taxes on a company in case the taxable income is reduced because the company applied a price higher or lower than the arm's length price to transactions with foreign related parties.

Through the transfer pricing regime, multinational enterprises undertaking transactions with foreign related parties may be exposed to the risk of double taxation. Against this backdrop, the APA program was introduced to help eliminate the risk of the double taxation prior to the actual international dealings. (Article 6 of the LCITA)

APAs are initiated by taxpayers and are finalized by the approval of the Commissioner of the NTS. Once an APA is concluded, the taxpayer can use the APA approved by the Commissioner as the most appropriate method during the covered APA term as long as the taxpayer complies with the critical assumptions.

APAs can be concluded either bilaterally or unilaterally. In bi-APAs, both the NTS and the foreign tax authorities are involved, whereas uni-APAs are only concluded between the taxpayer and the Korean tax authority.

Bi-APAs are more useful in addressing the issue of double taxation related to transfer pricing. However, bi-APAs usually take more time for conclusion compared to uni-APAs, as the former involves negotiation process with the relevant foreign tax authorities.

Even though the APA is an arrangement on the future application of the TPM between the taxpayer and the tax authorities, the taxpayer may also request a rollback of the proposed TPM to tax years prior to the proposed APA term.

## **2. APA History**

In 1996, the Republic of Korea joined the Organization for Economic Cooperation and Development (OECD) as the 29th member. As part of the preparation for the accession, the LCITA was enacted in late 1995 so as to reflect the internationally accepted taxation standard in Korea's tax law.

The law covers a wide range of international taxation issues, such as transfer pricing (TP), thin capitalization and tax haven. The transfer pricing part of the law provides the legal ground for applying the APA rule.

Korea concluded its first APA with the United States in May, 1995. The NTS has so far received a total number of 255 APA requests with 158 cases concluded as of the end of 2010. In recent years, the Korean competent authority has received an increasing number of APA requests. The Korean tax authority has the most number of APA negotiations with the United States, Japan, China. In 2007, the NTS signed its first two APAs for China-based Korean subsidiaries with the Chinese counterpart.

- . Established the LCITA in 1995**
  
- . Joined the OECD in 1996**
  
- . Concluded the first APA with the US in May, 1997**
  
- . Concluded the first APA with China in Nov., 2007**
  
- . Concluded the first APA with Germany in April, 2009**

## **3. Taxpayer Benefits from APA**

First, taxpayers can reduce the potential tax uncertainty arising from the future application of the transfer price regime related to their transactions with foreign related parties. If a taxpayer files tax returns and pays taxes according to the

agreed APA, the taxpayer can concentrate on business without worrying about a possible transfer pricing audit. Depending on the situation, taxpayers may request the extension of the covered APA term so that they may reduce the risk of transfer pricing audits for a prolonged period of time.

Second, taxpayers can allocate the company's assets or human resources more efficiently. If an APA is concluded, the taxpayer may place the human resources and money in more productive areas, which, otherwise, would have been used to respond to a transfer pricing audit. Moreover, an APA helps taxpayers address the transfer pricing issue at a more affordable cost when compared to the considerable time and money spent for hiring tax advisors and filing a law suit in the event of a tax audit.

Third, an APA eliminates the possibility of double taxation. In bi-APAs, where both sides reach an agreement, there is no possibility of double taxation as corresponding and compensating adjustments are made according to the APA agreed between the two tax authorities. Since a uni-APA does not involve an agreement between the two relevant tax authorities, the taxpayer should request a Mutual Agreement Procedure (MAP) for resolution of a double taxation issue.

Lastly, an APA helps taxpayers make reasonable decisions on transfer pricing. In an APA process, professional tax advisors and the TP experts of the NTS are involved, making it possible to strictly apply the internationally accepted tax standards. Moreover, the taxpayer and the Korean tax authority can make more reasonable decisions in APAs since the Korean competent authority negotiates on equal terms with the other tax authorities to reach an agreement. Since taxpayers are allowed to present their opinion anytime throughout APA process, and exchange their positions with the tax authorities, both the taxpayer and the NTS can reach a mutually satisfactory agreement.

## 4. APA Process

### 4.1 Pre-filing Conference

A pre-filing meeting is informally held between a taxpayer and the NTS prior to a formal APA proposal, giving taxpayers a general idea of APA program such as eligibility to request an APA. The taxpayer may request a pre-filing meeting on an anonymous basis. During the meeting, the applicant and tax officials discuss the APA process, key points of application, required information and documentation to be filed. The meeting also provides opportunities for the applicant to better understand the general process and operation of APA. The NTS encourages taxpayers to seek pre-filing meetings, because the meeting helps facilitate evaluation of the APA request.

The following illustrates key points that are usually discussed during the pre-filing meetings.

① **Background of APA request**

- Whether there are any intensions other than deciding TPM and preventing double taxation on actual international transactions.

② **Records of tax returns, such as operating margin that are filed prior to the tax years covered by the APA**

- For example, if the proposed profit level indicator is much higher or lower compared to the arm's length price that was declared prior to the proposed APA term, the applicant and the tax office will discuss why there is such a big difference.

③ **Eligibility of the taxpayer to apply for APA**

- Whether the other party to the transaction is the applicant's foreign related party as prescribed under the LCITA, and;  
- Whether the other party to the applicant's requested transaction is a resident of a country with whom Korea has a tax treaty.

④ **Whether the covered transaction is suitable for APA**

⑤ **Appropriateness of the proposed TPM**

- Appropriateness of comparables, if necessary

## **4.2 Formal APA Proposals**

Applicants should submit an application form (Form 3 of Article (3), Section (1) of the Ministerial Enforcement Decree of the LCITA) to the International Cooperation Division by the end of the first taxable year of the covered period. The application form should contain information such as the covered APA term, covered transactions, involved parties, and TPM.

Taxpayers usually apply for a 5-year term APA. If taxpayers wish to request a rollback for tax years prior to the covered APA period, they may apply for within a period of 5 years in the case of bi-APAs and for within a period of 3 years in the case of uni-APAs.

The taxpayer should submit the following documents along with an APA application form.

**Documents required for APA application (Article 9 of the Presidential Enforcement Decree of the LCITA)**

- Overview of business: Business profile, organization, and investment relationship
- Financial statements for the past 3 years, a copy of tax returns, a copy of contracts for international transaction, and relevant documents
- Documents detailing suggested transfer pricing methodology as listed below:
  - a. Methods used to evaluate comparability and adjustment of difference in factors determining comparability as provided in Article 5(2) and Article 6(2)
  - b. Where the financial statements of comparable companies are used, the difference in the accounting principle and its adjustment
  - c. Where financial or cost data segmented by transaction item is used, segmentation standards
  - d. Where two or more comparables are used, the arm's length range and the method for its calculation
  - e. Information explaining conditions or assumptions for the TPM
- Where Article 7(2) applies, method used to adjust difference between actual transaction prices and arm's length price
- Where the taxpayer requests a MAP, the MAP application form as designated by the Ministry of Strategy and Finance
- Other data supporting the appropriateness of the TPM suggested for an APA

If the taxpayer fails to submit any of these documents, the application may be rejected. There is no fee charged for APA application.

The applicant may send an APA proposal to the following address:

International Cooperation Division, National Tax Service

86, Jongno5-gil, Jongno-gu, Seoul, 110-705

Telephone: (+82) 397-1406~8

### **4.3 Review**

The application form and data submitted for APAs are evaluated by tax officials who work on their assigned countries/regions.

When evaluating whether the proposed TPM is appropriate, the NTS may request the taxpayer to explain the data submitted or to provide additional information. In addition, the taxpayer may be required to change or modify the TPM, or to change comparable companies or transactions, or to add assumptions or conditions for the application of TPM.

Before the approval of the APA, the applicant may modify the contents of application or withdraw the application.

Taxpayers are welcome to participate in the process of APA evaluation directly or through their representative. We do our best to provide taxpayers and their representatives opportunities to present their case to us and to discuss with us, to ask any questions they may have in the process of evaluation, and ultimately to reduce the duration of the evaluation.

### **4.4 Process of Mutual Agreement Procedures**

When taxpayers apply for bi-APAs, the NTS processes the MAP with the relevant foreign competent authorities at the request of taxpayers.

However, the NTS may approve the requested APA without using a MAP, if the applicant does not initially request a MAP, or if a MAP for bi-APAs is suspended for the following reasons and the taxpayer seeks a uni-APA.



Ⓐ Where agreements are not reached between the two tax authorities within three years from the receipt of APA request, and the Commissioner of the NTS ceases the mutual agreement procedure at his discretion

Ⓒ Where the NTS and the foreign competent authorities decide to end the

#### **4.5 Benefits and Conclusion of APA**

If the NTS and the relevant foreign tax authorities agree on a TPM during the MAP, the NTS may approve the requested APA based on the result of the MAP. If an APA is approved, the Commissioner of NTS and the applicant must observe the approved methodology. If the applicant files a tax return in accordance with the APA during the covered period, the tax returns are deemed filed according to the arm's length principle.

In a bi-APA, if the NTS and the foreign competent authorities reach an agreement, the applicant is notified by the Commissioner of the NTS of the contents of the agreement within 15 days from the following day of the MAP conclusion. The applicant should submit an opinion in writing to the Commissioner of the NTS, within 2 months from the receipt of the notification, whether or not he agrees with the MAP result.

If the applicant is not satisfied with the result and does not submit a written consent within the period, the initial application of APA is deemed to have been withdrawn. Even if the result of MAP and the contents of APA request are not the same, it is deemed, with consent of the applicant, that the taxpayer initially requested what was agreed in the MAP.

If the Commissioner of the NTS receives a written consent from the applicant, the Commissioner should approve the APA within 15 days of receipt of consent and notify the applicant of the approval.

In uni-APAs, the NTS should decide whether to approve an APA within 2 years from request. As in bi-APAs, the same rule applies regarding the notification of contents of APAs determined, approval/rejection and withdrawal of APA, effect of revised APA, and notification of the approval of the APA.

The applicant may request renewal of an APA when it expires.

#### **4.6 Submission of Annual Report**

If an APA is approved, the taxpayer must submit four copies of annual report with the following information included within six months from the following day of corporate tax return period for the covered tax year (Article 12 of the Presidential Enforcement Decree on the LCITA).

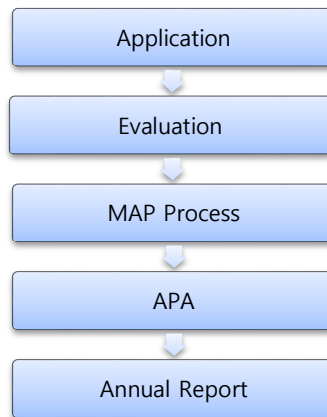
- Ⓐ Critical assumption and its realization as a prerequisite of the approved TPM
- Ⓑ Arm's length price calculated by the approved TPM and its calculating process
- Ⓒ Where applicable, the method used to adjust the difference between actual transaction prices and arm's length price

#### **4.7 Cancellation, Withdrawal and Revision of APA**

The Commissioner of the NTS may cancel or withdraw an APA approval for the following cases (Article 13 of the Presidential Enforcement Decree on the LCITA).

- Ⓐ Where the taxpayer fails to file an annual report, or includes false information on material matters in the annual report.
- Ⓑ Where taxpayer fails to observe the provisions or conditions of the APA.
  - For example, the applicant fails to comply with the specific method for compensating adjustment in the case where the APA was approved under that specific condition. (A compensating adjustment refers to adjustment made to difference between the actual price and the arm's length price calculated by the agreed TPM)
- Ⓒ Where critical assumptions or material parts of the assumptions fail
- Ⓓ Where the contents of approved APA are not applicable due to a change

If a material change occurs in critical assumptions that is one of the conditions for an APA approval, and makes the APA inapplicable, the applicant may request to revise the APA.



## 5. Protection of Applicant's Rights

Where an APA is rejected by reason of inappropriate APA request, the NTS shall return all the documents the applicant submitted. Also, all the information the taxpayer presents for an APA request will not be used for purposes other than APA evaluation and post-APA management.

(Article 9, Section 4 and 5 of the Presidential Enforcement Decree on the LCITA)

## 6. Statistics

### 6.1 Number of APAs Received and Processed

Year	Uni-APAs			Bi-APAs			Total		
	Received	Processed	Pending	Received	Processed	Pending	Received	Processed	Pending
~ 2004	18	9	19	38	16	37	56	25	31
2005	15	4	20	10	3	29	25	7	49
2006	12	8	24	12	16	25	24	24	49
2007	19	13	30	13	7	31	32	20	61
2008	13	16	27	22	14	39	35	30	66
2009	19	20	26	21	7	53	40	27	79
2010	18	15	29	25	10	68	43	25	97
2011	15	11	33	30	13	85	45	24	118
Total	129	96	-	171	86	-	300	182	-

We received 45 APA requests in 2011, and the number of APA requests has increased every year since 2004. The increase may be attributable to enhanced awareness of taxpayers about the concept and importance of transfer pricing, and efforts of the NTS to encourage a wide use of APA.

The number of bi-APAs is larger than that of uni-APAs since in bi-APAs, the other tax authorities can make corresponding adjustment to the taxpayers, resolving the issue of double taxation.

## 6.2 Period for APA Completion

From 1997, when a first APA was concluded, to 2011, the average time to conclusion (i.e., from receipt of application to conclusion) was 1 year and 8 months for uni-APAs and 2 years and 3 months for bi-APAs. It took more time to conclude bi-APAs than uni-APAs, because the former involves mutual agreement procedures with the relevant foreign competent authority.

Type	Average time to conclusion	Time taken			
		Total	2 yrs and less	More than 2 yrs ~ 3 yrs and less	More than 3yrs
Uni-APA	1 year and 8 months	96	96	-	-
Bi-APA	2 years and 3 months	86	41	28	17

In order to facilitate the prompt conclusion of APAs, the NTS has endeavored to coordinate each other's opinions. For example, in bi-APAs, we exchanged position papers and held face-to-face meetings more frequently. As a result, the average time to conclude was 1 year and 9 months for the 13 bi-APAs concluded in 2011, a timeframe which is 6 months shorter than the average of 2 years and 3 months for the accumulated period.

For uni-APAs, we introduced the concept of the Management by Objective for each member of the APA team in processing cases. As a result, the average time to conclude the 11 uni-APAs in 2011 was 1 year and 7 months, 1 month shorter than the average time of 1 year and 8 months for the accumulated period.

Type	Average time taken for APAs concluded in 2011	Average time taken for APAs concluded for all years	Shortened by
Uni-APAs	1 year and 7 months	1 year and 8 months	1 month
Bi-APAs	1 year and 9 months	2 years and 3 months	6 months

※ Among 24 APAs processed in 2011, 7 were renewed, and the average processing time was 1 year 2 months.

### 6.3 Covered Transactions

There are generally three types of transactions that may be covered by APA: tangible, intangible and service transactions.

Type	Total	Transactions for which APAs were requested		
		Tangible	Intangible	Service
Concluded in 2011	24	13	1	10
Total cumulative	182	126	13	43

Among the 24 APAs concluded in 2011, transactions involving tangible assets accounted for 54 percent of the total with 13 APAs. The cases mainly involve such transactions as manufacturing after purchasing the raw materials or semi-finished goods from the related parties or purchasing and reselling finished goods.

Intangible properties transactions include payment of royalties for use of technology and trademark, and license fee, etc. Intangible properties transactions that also involve tangible properties transactions or service transactions were classified as either a tangible asset transaction or service transaction.

10 APAs covered service transactions, such as sales support or technical assistance service between related parties.

## 6.4 APA Term

Tax years covered by APAs	2010			Total cumulative		
	Uni-APAs	Bi-APAs	Total	Uni-APAs	Bi-APAs	Total
2 Years	-	-	-	2	2	4
3 Years	2	1	3	16	10	26
4 Years	-	-	-	1	10	11
5 Years	9	9	18	75	54	129
6 Years	-	-	-	-	4	4
7 Years	-	3	3	-	5	5
8 Years	-	-	-	-	1	1
Total	11	13	24	94	86	180*

\* 2 APAs concluded in 2010 covered only rollback years.

Of the 180 APAs processed by 2011, 129 (71%) APAs covered a period of 5 years.

18 (75%) out of 24\* APAs concluded in 2011 covered a period of 5 years.

Rollback	2011			Total cumulative		
	Uni-APAs	Bi-APAs	Total	Uni-APAs	Bi-APAs	Total
1 Years	-	1	1	8	4	12
2 Years	-	-	-	3	4	7
3 Years	5	1	6	30	2	32
4 Years	-	2	2	2	4	6
5 Years	-	1	1	-	13	13
6 Years	-	-	-	-	1	1
Total	5	5	10	43	28	71

Among the 182 APAs concluded by 2011, 71 cases (39%) of the total covered a rollback, of which 13 cases covered a 5-year rollback.

Out of the 24 cases concluded in 2011, 10 cases (42%) covered a rollback, and 7 cases covered a rollback of 3 years or less.

## 6.5 APAs by Industry

Types of Business	2011			Total cumulative		
	Uni-APAs	Bi-APAs	Total	Uni-APAs	Bi-APAs	Total
Computer/LCD/Cellphone	-	1	1	4	19	23
Automobile/Transportation Equipment	1	1	2	5	7	12
Chemical/Pharmaceutical	2	-	2	19	6	25
Financial service/Securities	1	-	1	10	1	11
Apparel	1	-	1	10	3	13
Food & Beverage	-	1	1	8	6	14
Publishing/Software	-	-	-	1	4	5
Machinery	2	-	2	11	7	18
Wholesale(General Trading)	-	3	3	12	9	21
Semi-conductor	2	3	5	5	16	21
others	2	4	6	11	8	19
Total	11	13	24	96	86	182

The 182 APA processed by 2011 covers 11 types of industry. Chemical /Pharmaceutical ranked top with 25 APAs, followed by Computer/LCD/Cellphone, Automobile/Transportation Equipment, and Semi-conductor.



## 6.6 APAs by TPM

TPM	2011			Total cumulative		
	Uni-APAs	Bi-APAs	Total	Uni-APAs	Bi-APAs	Total
Comparable uncontrolled price method	-	-	-	2	1	3
Resale price method	-	1	1	1	6	7
Cost plus method	-	-	-	4	1	5
Profit split method	-	1	1	3	2	5
Other reasonable methods	-	-	-	4	4	8
Transactional net margin methods	11	11	22	82	72	154
Operating margin	6	5	11	42	34	76
Full cost markup	3	3	6	15	11	26
Value-added cost markup			0	0	1	1
Return on asset			0	2	1	3
Berry Ratio	2	3	5	23	25	48
Total	11	13	24	96	86	182

For APAs concluded by 2011, transactional net margin method (TNMM) was applied most as the TPM. Of the total 182 APAs concluded, 154 cases (85%), applied TNMM.

A total of 76 APAs (42 uni-APAs, 34 bi-APAs) were concluded applying TNMM with operating margin as the profit level indicator. The next most frequently applied profit level indicator was Berry Ratio, which accounted for 48 APAs (23 uni-APAs and 25 bi-APAs).

## 6.7 APAs by Country

Out of the total 182 cases concluded by the year 2011, 139 cases (or 76% of the total) were inbound transactions, and the remaining 43 cases (24%) were outbound transactions.

Most of the outbound cases were concluded through mutual agreement procedures with foreign tax authorities.

(unit : number)

Transaction Type	2011			Cumulative Total		
	Uni-APA	Bi-APA	Total	Uni-APA	Bi-APA	Total
Inbound	9	9	18	92	47	139
Outbound	2	4	6	4	39	43

### Inbound Outbound

Country	2011			Cumulative Total		
	Uni-APA	Bi-APA	Total	Uni-APA	Bi-APA	Total
USA	5	2	7	24	36	60
Japan	2	4	6	21	22	43
China	-	2	2	2	7	9
U. K.	1	1	2	8	5	13
Singapore	-	-	-	8	-	8
Hongkong	1	-	1	13	-	13
Swiss	-	1	1	6	6	12
Sweden	-	-	-	3	-	3
Australia	-	-	-	-	4	4
Others	2	3	5	11	6	17
Total	11	13	24	96	86	182

As of December 31, 2011, the NTS concluded the most number of APAs with the US with 60 cases, followed by Japan with 43.

The number of APAs in process by country as of the end of 2011 is as follows.

Country	Bi-APAs	Uni-APAs	Total
U.S.	10	21	31
Japan	6	25	31
China	-	12	12
France	2	3	5
U.K.	2	2	4
Singapore	2	1	3
Germany	-	5	5
Canada	1	3	4
Switzerland	3	5	8
Others	7	8	15
Total	33	85	118

As of December 31, 2011, the U.S. and the Japan ranked top on the list of partner countries for APAs with 31 cases respectively, followed by the China with 12 cases

## 7. APA Team

Currently, the APA team is in operation under the International Cooperation Division of the NTS head office, handling relevant work such as receipt, evaluation, and approval of APAs.



There are five APA teams that are assigned to cases of specific countries. APA teams consist of skilled tax officials with rich experience in transfer pricing related audits and international tax laws, and also with a good command of foreign languages and international negotiation skills.

The APA team members also participate in OECD meetings where they discuss with other country representatives from other OECD countries the revision of the OECD Model Convention Commentaries and the OECD Transfer Pricing Guidelines. This is part of the efforts to better serve the multi-national businesses in line with the international taxation standard.