Korea:  
Supreme Court rules on taxation of patents

Korea’s Supreme Court issued a decision on 27 November 2014 concluding that payments made for the use of a patent registered outside Korea should not be considered Korea-source income for purposes of the Korea-US tax treaty, regardless of whether the patent was used in manufacturing or sales activities in Korea.

Background

Under article 93 of Korea’s Corporate Income Tax Law (CITL), income for the use of intangible assets (including patents) in Korea, or income paid in Korea, will be treated as Korea-source income that is subject to withholding tax. The 20% domestic withholding tax (plus the 10% local income surtax) is reduced to 15% (16.5%, including the 10% local income surtax) under the Korea-US tax treaty. Under article 6(3) of the treaty, however, a payment for royalties will be treated as Korea-source income only if the payment is made for the use of, or the right to use, the property giving rise to the royalties within Korea.

In 2007, the Korean Supreme Court ruled that a patent is effective only in the jurisdiction(s) in which it is registered, in accordance with the territorial principle applicable to patents. Therefore, a payment for the use of a patent would be treated as Korea-source income only if the patent is registered in Korea; based on this interpretation, if a patent is registered only outside Korea, a payment for the use of the patent should not be considered Korea-source income.

Due to the conflict between the CITL and the language in Korea’s tax treaties, the CITL was amended in 2008 to provide that where a patent is registered outside Korea, but it is used in manufacturing or sales activities in Korea, the patent will be deemed to be used in Korea and, hence, will give rise to Korea-source income.

Relying on the amended CITL, the Korean tax authorities have taken the position that withholding tax can be levied on royalties paid for the use of a patent in Korea, even if the patent is not registered in Korea.

Supreme Court decision

The Supreme Court held in its November 2014 decision that a payment for the use of a patent that is registered only in the US, and not in Korea, does not constitute a Korean-source royalty payment, regardless of whether the patent is used in manufacturing or sales activities in Korea. The Supreme Court based its conclusion on the following rationale:

- Even though the CITL was amended to provide that a patent that is not registered in Korea, but is used for manufacturing or sales in Korea, is deemed to be used in Korea, the Korea-US tax treaty takes precedence over domestic legislation (as confirmed by Korea’s International Tax Coordination Law);
- Under the court’s interpretation of the Korea-US tax treaty, a payment made for the use of a patent may be deemed to be Korea-source income only if the patent is registered and used in Korea; and
• Thus, if a patent is registered only in the US, it is irrelevant for purposes of the treaty whether the patent is used in manufacturing or sales activities in Korea.

Comments

This is the first Supreme Court decision rendered on this issue after the CITL was amended, and it clearly states that a tax treaty takes precedence over domestic tax law. Thus, whether a patent that is not registered in Korea actually is used in Korea is irrelevant in determining whether the payment constitutes Korea-source income under article 6(3) of the Korea-US treaty. The Supreme Court seems to have interpreted the place of use of a patent for purposes of article 6(3) of the treaty to be the place where the patent is registered. However, it is not entirely clear whether this interpretation also would apply where a Korean company manufactures products using a patent that is not registered in Korea, but sells the manufactured products in Korea (in contrast, in the case before the Supreme Court, the Korean company sold the manufactured products in the US market).

According to Korean tax law, a taxpayer can file an amended tax return to claim a refund of inappropriately paid withholding tax within three years after the original due date for filing the return. It is expected that a number of amended tax returns will be filed to claim a refund of withholding tax based on the Supreme Court decision.

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