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**Transfer Pricing Regulations and the Practices of
Foreign Multinational Enterprises
in Korea**

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I. Introduction

The spread of the activities of multinational firms led many governments to a difficult problem of determining the allocation of taxable profits of these firms. Since transfer price may be manipulated to affect the allocation of income and expenses between the countries involved, it is generally agreed that for tax purposes, it may be appropriate to correct the allocation of profits between members of a corporate group to eliminate the effect of such manipulation (OECD, 1993).

However, Korean government began to consider the transfer pricing as an important tax issue only in recent years. Since most of taxes on profits from foreign direct investments(FDIs) were exempted, the primary concern of the tax authorities related to foreign investments was to provide appropriate tax incentives rather than applying regulations on transfer pricing. Furthermore, the volume of foreign direct investments in Korea (FDIK) was relatively small.

Korean government has been focussing on transfer pricing since the middle of 1980's as its policy on FDIK was substantially deregulated and the volume of FDIs both into and from Korea increased. The number of foreign multinational firms in Korea became about 2,500 and Korean firms invested abroad became more than 2,700 by the end of 1988. With this increasing number of foreign multinationals (and also as many other countries started to introduce regulations on transfer pricing)¹, Korean tax authorities became increasingly conscious about streamlining the tax laws regarding foreign multinationals' operation.

The government revised the tax law to introduce transfer pricing rules at the end of 1988, which became effective from January 1, 1989. Before the tax reform, Korean tax authorities were able to adjust transfer prices of multinational companies by applying article 20 of the Corporate Tax Law (CTL) which provides that a transaction between 'related parties' in a 'special relationship' with tax payer may be subject to an arm's length adjustment. The situations in which transactions were considered unreasonable were described solely in 'Enforcement Decrees of the Corporate Tax Law (ED-CTL)', which lists categories of transactions characterized as disguised distributions. However, these rules were not adequate enough to enforce transfer pricing regulations since they did not provide the rules to decide the arm's length price and so on. To address this problem, Korean Government revised ED-CTL. It also issued "Regulations Regarding Enforcement of Transfer Pricing Legislation (The Regulations)" on January 24, 1990. The Regulations, in addition to the adoption of the methods commonly used to determine the arm's length price, also contains provisions mandating disclosure of information. Korean regulations on transfer pricing are founded squarely on the 1979 OECD recommendation for transfer pricing rules(OECD, 1979).

This paper briefly reviews the historical perspectives of foreign direct investments (both into and from Korea) and Korean policies on transfer pricing. Section II reviews the size and distribution of FDIs by industry and by country, and the major motivations behind FDIs. Section III briefly introduces the historical development of and the current regulations on transfer pricing in Korea. It discusses about the companies subject to transfer pricing regulations, rules for determination of transfer pricing, burden of proof, and disclosure requirements. Section IV

attempts to investigate the extent to which foreign multinational enterprises (FMEs) in Korea engage in allocating income and expenses through transfer pricing. It compares the reported profit rates of FMEs with those of domestic firms in the same industries. It also compares the effective tax rates on FMEs with those on domestic firms. The last section briefly summarizes the paper and draw some implications for the future course of transfer pricing regulations in Korea.

II. Recent trends of foreign direct investments in Korea and Korean direct investments abroad

II.1. Foreign direct investments in Korea(FDIK)

A. The trends of FDIK

Direct investment inflows into Korea, which began in 1962, were strictly controlled by the government in the 1960's and 1970's. Korean policy on FDIK in these two decades had two facets. It generally restricted direct investment inflows while providing incentives for those deemed essential for the development of Korean economy.² As a result of the overall restriction policy on FDIK, the volume of FDIK was kept small even though it showed high annual growth rates during this period. Annual inflows of direct investments were less than \$200 million by 1982(Table 1). This compares to annual net foreign borrowing of \$2,795 million in the same

year. Net direct investment inflows³ into Korea were less than 5 per cent of net long term capital inflows including loan, portfolio investments and direct investments during 1974-1981(Table 2).

In the period of 1977-1981, new direct investment inflows dropped by 53 per cent and total investments decreased by 18 per cent compared to those of the previous 5 years(Table 1). This decline was mainly due to the political instability and economic recession in Korea in the early 1980's associated with the assassination of President Park as well as the worldwide economic recession. However, FDIK began to rise from 1982. During 1982-1986, total FDIK increased by 145 per cent compared to the previous five years. In the next five years(1987-1991), it increased by 219 per cent. This rapid growth can be attributed to the improved investment environments owing to the rapid economic growth and to the substantial deregulation of Korean policy on foreign direct investments.

Table 3 shows that the ratio of FDIK to domestic fixed capital formation. It was low in Korea than in other countries. In the 4 years from 1986, FDIK accounted for only 1.6 per cent of total domestic fixed capital formation. This ratio was 35.2 per cent in Singapore, 19.1 per cent in Hong Kong, 12.3 per cent in the U.K., 9.6 per cent in Malaysia, and 6.7 per cent in the U.S. The only country in the table in which foreign direct investments were less important than in Korea is Japan.

Table 1 The trends of FDIK¹⁾

unit: millions of dollars, %

Year	New investments		Total investments ²⁾	
	Amounts	Growth rate	Amounts	Growth rate
1962-1966	46.5		47.4	
1967-1971	169.1	264.0	218.6	361.1
1972-1976	610.5	261.0	879.4	302.3
1977-1981	288.8	-52.7	720.7	-18.1
1982-1986	686.9	137.8	1,767.7	145.3
1987-1991	2,753.5	300.9	5,635.9	218.8
1977	53.1		83.6	
1978	56.3	6.0	149.4	78.7
1979	98.3	74.6	191.3	28.0
1980	42.7	-56.6	143.1	-25.2
1981	38.5	-9.8	153.2	7.1
1982	101.1	162.6	189.0	23.4
1983	91.9	-9.1	269.4	42.5
1984	217.7	136.9	422.3	56.8
1985	144.2	-33.8	532.2	26.0
1986	131.9	-8.5	354.7	-33.4
1987	556.8	322.1	1,063.3	199.8
1988	583.1	4.7	1,283.8	20.7
1989	426.6	-26.8	1,090.3	-15.1
1990	336.6	-21.1	802.5	-26.4
1991	850.3	152.6	1,396.0	73.9
1992	328.0	-61.4	894.5	-35.9
1962-1992	4,883.3		10,164.2	

Note: 1) The amounts permitted or approved during the period.

2) Total investments include both new investments and increased investments.

Source: Economic Cooperation Bureau, Ministry of Finance, *Trends in Foreign Investments*, various issues.

Table 2 Net long-term capital inflows into Korea

unit: millions of dollars, %

	Loan & inv.(A)	Direct inv. (B)	Portfolio inv. (C)	B/A	B/C
1974-1981	11,959.1	583.0	312.6	4.9	186.5
1982-1986	5,533.4	916.2	1,817.8	16.6	50.4
1987-1991	-1,817.4	4,061.3	3,508.6	-	115.7

Source: The Bank of Korea, *Economic Statistics Yearbook*, various issues.

Table 3 The role of FDIs in domestic capital formation

unit: %

	FDI/Gross domestic fixed capital formation				FDI stock/ GDP
	1971-1975	1976-1980	1981-1985	1986-1989	1989
Japan	0.1	0.05	0.1	-0.01	0.6
U.K.	7.3	8.4	5.4	12.3	16.2 ¹⁾
U.S.	0.9	2.0	3.0	6.7	7.3
Hong Kong	5.9	4.2	6.9	19.1	22.2
Korea	1.9	0.4	0.5	1.6	2.1 ¹⁾
Singapore	15.0	16.6	17.4	35.2	91.7
Malaysia	15.2	11.9	10.8	9.6	27.7 ²⁾
Indonesia	11.6	2.4	1.0	2.3	9.3
Thailand	3.0	1.5	3.1	3.6	7.0
Taiwan	1.4	1.2	1.5	3.6	5.5 ¹⁾

Note: 1) 1988

2) 1987

Source: U.N., *World Investment Report 1992*.

B. The structure of FDIK

FDIK in 1960's and 1970's were concentrated in a few manufacturing sectors since FDIK in most non-manufacturing industries were restricted. About 75 per cent of FDIK by the end of 1981 were invested in manufacturing sectors (Table 4). Among manufacturing sectors, textile and clothing, electricity and electronics, and chemicals together accounted for more than 40 per cent of total FDIK. Hotel industry is the only non-manufacturing industry which received more than 10 per cent of total FDIK in this period.

Hotel industry attracted substantial FDIK in the first half of 1980's. This was related to the preparation of 1988 Seoul Olympic. With this increase in the inflows of foreign capital in hotel industry, the share of FDIK in manufacturing sectors decreased. However, the portion of manufacturing industries began to rise again in the late 1980's as direct investment inflows in hotel industry decreased. The portion of chemicals, medicine, machinery, electricity and electronics, and transport equipment increased or kept high in the 1980's, while those of textile and clothing, and metals decreased. These changes seem to reflect the structural change of Korean industry in this period from labor intensive industries to capital and technology intensive sectors.

Table 5 shows that during the period 1962-1992, the composition of FDIK by home country has changed although the U.S., Japan and the Netherlands remain the largest investors in Korea.

Table 4 Composition of FDIK by industry

unit: %

Industry	1962-1981	1982-1986	1987-1991	1992	1962-1992
Agriculture, Fishery, Forestry	0.80	0.32	0.26	0.09	0.36
Mining	0.34	0.24	0.10	0.16	0.17
Manufacturing	74.47	52.49	69.02	72.33	67.44
Food	3.13	4.82	4.08	5.25	4.14
Textile & Clothing	10.43	0.94	1.26	2.73	3.02
Chemicals	18.05	6.68	16.37	24.56	15.91
Medicine	1.11	4.24	3.44	6.82	3.45
Petroleum	4.54	0.30	10.02	0.00	6.44
Metals	5.36	1.22	1.16	1.92	2.01
Machinery	6.41	3.05	7.41	4.28	6.19
Electricity & Electronics	14.67	14.16	14.26	7.45	13.72
Transport Equipment	4.42	14.44	7.64	4.47	7.95
Service	24.40	46.95	30.63	27.42	32.04
Trading	0.02	0.24	2.87	9.44	2.47
Hotel	12.85	38.01	12.06	0.45	15.70
Financing	5.58	3.77	7.38	4.39	6.16
Insurance	0.16	0.03	3.16	0.44	1.82
Total	100.00	100.00	100.00	100.00	100.00

Source: The same as those of Table 1.

Table 5 Composition of FDIK by source country

unit: %

	1962 - 1971	1972- 1981	1982- 1986	1987- 1991	1992	1962-1992
U.S.	45.2	23.2	32.9	26.2	42.4	28.8
Japan	36.8	58.0	49.6	37.7	17.4	41.1
Hong Kong	2.2	3.8	3.7	1.9	1.1	2.4
Germany	1.0	2.1	1.5	5.1	13.5	4.7
U.K.	4.0	1.3	1.9	3.2	2.7	2.7
France	0.2	0.9	1.6	2.7	3.3	2.2
Netherlands	2.3	1.7	1.1	13.3	4.9	8.3
Switzerland	0.0	1.9	3.7	3.9	4.1	3.5
Others	8.2	7.1	3.9	6.0	10.9	6.3
Total	91.8	92.9	96.1	94.0	89.2	93.7

Source: The same as those of Table 1.

II.2. Korean direct investments abroad(KDIA)

Korea had strong foreign exchange control until the middle of 1980's and direct investment outflows were strictly restricted in relation with foreign exchange control. By the middle of 1980's, Korean firms were permitted to invest abroad only if they were to exploit natural resources or the investments were required to expand export markets. Consequently, the volume of annual outflows were small until the middle of 1980's. The annual inflows were no more than \$110 million by 1984(Table 6). They were mainly to developing countries in Asia, Africa, and Middle East to exploit natural resources.

Table 6 The trends of KDIA

unit: millions of dollars, %

Year	Total investments		Net investments ¹⁾	
	Amounts	Growth rate	Amounts	Growth rate
1968-1976	58.19		52.85	
1977-1981	136.95	135.35	116.23	119.98
1982-1986	559.39	308.46	476.00	309.53
1987-1991	3,288.55	487.88	2,727.80	573.07
1977	21.22		18.73	
1978	41.84	97.12	39.54	111.14
1979	21.05	-49.69	16.40	-58.53
1980	17.76	-15.60	12.80	-21.97
1981	35.08	97.48	28.79	125.03
1982	100.84	187.45	97.51	238.66
1983	108.92	8.01	102.59	5.21
1984	50.19	-53.92	48.18	-53.03
1985	115.56	130.27	66.54	38.10
1986	183.88	59.12	161.18	142.24
1987	410.51	123.25	320.90	99.09
1988	223.76	-45.49	164.10	-48.86
1989	569.59	154.55	392.39	139.12
1990	959.33	68.42	813.19	107.24
1991	1,125.36	17.31	1,037.22	27.55
1992	1,255.09	11.53	1,133.73	9.30
1962-1992	5,298.16		4,506.63	

Note: 1) net investments = total investments - liquidation, etc.

Source: Foreign Exchange Department, The Bank of Korea, *Overseas Direct Investment Statistics Yearbook*, various issues

The substantial deregulations in the middle of 1980's encouraged KDIA in the late 1980's. In addition, the worsened domestic investment environments due to labor disputes and high wages prompted Korean investors as well as foreign investors to seek alternative investment opportunities in other countries. Many Korean manufacturing firms especially in apparel, leather and fur, and footwear industry moved their manufacturing plants to other Asian countries such as Thailand, Indonesia, and Malaysia in late 1980's, and to China in more recent years. In 1990, KDIA outpassed FDIK.

Table 7 Composition of KDIA by industry

unit: %

Industry	1962-1981	1982-1986	1987-1991	1992	1962-1992
Mining	0.83	50.47	19.30	11.96	20.17
Forestry	18.08	6.31	1.24	0.15	2.14
Fishery	5.54	1.11	2.96	2.07	2.65
Manufacturing	19.19	24.79	48.82	51.85	45.90
Construction	15.73	2.96	1.21	0.04	1.65
Transport	1.40	0.20	0.44	0.78	0.53
Trading	19.70	9.92	17.53	24.16	18.38
Real estate	11.12	1.02	0.68	2.92	1.63
Others	8.36	3.24	7.82	6.06	6.94
Total	100.00	100.00	100.00	100.00	100.00

Source: The same as those of Table 6

The structure of KDIA by industrial sector in 1980's is quite different from that in 1970's. The share of KDIA for the exploitation of natural resources in Asian and African countries were reduced starting the middle of 1980's while those in manufacturing sectors increased. The portion of KDIA in manufacturing sectors increased to about 49 per cent in the period of 1987-1991 from about 25 per cent of the previous 5 years (Table 7). Especially, KDIA in apparel, leather and fur, footwear, rubber products, and miscellaneous products in Asian countries increased rapidly from the late 1980's. These investments were seeking cheap labor as well as to circumvent trade barriers. The recent increase in KDIA in advanced countries were also intended to overcome increasing trade barriers of these countries. These investments are concentrated in trading and manufacturing.

Table 8 Composition of KDIA by region

	unit: %				
	1968-1981	1982-1986	1987-1991	1992	1968-1992
Asia	38.77	12.53	31.59	44.28	32.85
Middle East	13.33	19.03	7.38	6.00	8.50
North America	20.34	39.35	44.70	31.20	40.04
Latin America	3.08	1.38	4.60	2.87	3.79
Europe	4.22	10.76	7.10	11.48	8.42
Africa	13.45	0.33	1.67	2.31	2.12
Oceania	6.80	16.62	2.96	1.86	4.29
Total	100.00	100.00	100.00	100.00	100.00

Source: The same as those of Table 6

Table 9 The motives for KDIA

unit: %

	North America, Europe	South-East Asia	China, Middle East, Africa	Latin America	Average
Low production costs	7.6	33.2	26.7	26.4	27.1
Market expansion	9.3	21.1	23.8	17.4	23.1
To avoid trade barriers	18.2	7.8	2.9	27.3	12.6
Raw material	4.5	8.6	9.5	5.0	7.4
Advanced technology	6.0	-	-	2.5	1.3
Relocation of excess capacity	-	4.7	6.7	5.0	4.6
Firm expansion strategy	22.7	21.6	27.6	12.4	20.8
Others	1.5	3.0	2.9	4.1	3.1
Total	100.0	100.0	100.0	100.0	100.0

Source: Federation of Korean Industries, *Survey of the Profitability of Overseas Investments in Manufacturing Industries*, 1991

According to Federation of Korean Industries' survey in 1991, the motivation of Korean firms' investments abroad are somewhat different depending on the country of destination (Table 9). For those who invested in South-East Asia or other less developed countries, "low production cost" is the most important reason for their investments abroad. "Market expansion" and "firm expansion strategy" are the next important reasons. On the other hand, "market expansion" is

the most important factor behind Korean investments in advanced countries. Korean firms also invest in advanced countries to circumvent trade barriers. These results confirm the conventional view that wage level, which is one of the most important factors affecting production cost, and trade barriers of importing countries are the key factors affecting KDIA.

III. Transfer pricing regulations in Korea

Transfer pricing became an issue for the Korean tax authorities after foreign direct investments were substantially deregulated in the middle of 1980's. The issue became more important as FDIK increased and regulations were further relaxed. The Korean Government revised the tax law and introduced new regulations on transfer pricing at the end of 1988, which became effective since January 1, 1989. Before the tax reform, Korean tax authorities were able to adjust transfer prices of multinational companies by applying article 20 of the Corporate Tax Law (CTL), entitled 'Rejection of Unfair Transactions between Related Parties', which provides that a transaction between the taxpayer and a person in a 'special relationship' with the taxpayer, may be subject to an arm's length adjustment. The situations in which transactions were considered unreasonable were described solely in 'Enforcement Decrees of the Corporate Tax Law (ED-CTL)', which lists categories of transactions characterized as disguised distributions. However, these rules made it difficult for the tax authorities to enforce transfer pricing regulations. In order to solve the problem, the Korean Government adopted the transfer pricing rules by establishing Article 46, Item 4 of ED-CTL, following the rules provided in the OECD

Transfer Pricing Report.⁴ Article 20 (Denial of Unjust Acts) of CTL and Article 46(Unjust Acts or Computation of Corporation) of ED-CTL provide the legal basis of the Korean transfer pricing rules(see Chang, 1994). In 1990, the National Tax Administration(NTA) adopted the guidelines for the enforcement of transfer pricing rules, entitled 'Regulations Regarding Enforcement of Transfer Pricing Legislation'. This regulation, in addition to the adoption of the methods commonly used to determine the arm's length price, also contains provisions mandating disclosure of information. In March of 1990, the NTA issued Notice 1990-4 and 1990-9, which set forth the requirements for submission of summary income statement of foreign related parties. While Korean Government has strengthened transfer pricing rules, Korean transfer pricing rules are founded squarely on the generally accepted standards recommended by OECD.

III.1 Companies subject to transfer pricing regulation

The Korean transfer pricing rules are unique in the sense that they apply only to corporations and only those that have conducted transactions with a so called 'related foreign company'. The term 'corporation' is defined to cover all corporations that are taxable under CTL Article 1, including all domestic corporations and foreign corporations having a permanent establishment in Korea. While taxpayers in most countries (including the United States) are struggling with subjective ownership and control standards, Korean authorities have sought to eliminate this problem by providing objective standards for the ownership and control which will bring the transfer pricing rules into effect. Only corporations that have conducted transactions

with a 'related foreign company' are subject to the Korean transfer pricing rules.⁵ The term 'related foreign company' refers to the specifically related parties enumerated in Article 46(1) and only those who have conducted overseas transactions with the corporation. Under Article 46(1), related foreign company includes those specially related to taxpayer companies through a personal relationship (e.g. shareholder, shareholder's relative, and shareholder's employees) as well as parties specially related to the taxpayer through legal ownership. The NTA found that the scope of the transfer pricing rules was too broad and in order to enable the NTA to enforce the rules more effectively, the scope of the related foreign company should be narrowed considerably under the new regulations.

NTA Regulations Nos. 1061 and 1062 were issued to enforce the above mentioned transfer pricing laws and regulations more effectively. The purposes of these regulations are to encourage taxpayers to comply with the above rules and minimize taxpayer's burdens and the tax authorities' administrative cost incurred in the tax audits of transfer pricing amount. In order to enhance efficiency of the tax administration on the transfer pricing issue, the scope of corporate taxpayers subject to these NTA regulations is narrowed to: (i) a foreign corporation that directly or indirectly owns 50 per cent or more of the total shares of the domestic corporation, (ii) a foreign corporation owned by the domestic corporation directly or indirectly by holding 50 per cent or more of the former's total stock, and (iii) a foreign corporation that directly or indirectly owns 50 per cent or more of the total shares of the foreign corporation which has a branch office in Korea. And the new rules apply to the following transactions:

(i) Transactions between a related foreign company and its Korean subsidiary company;

this applies to a foreign corporation directly or indirectly owning 50 per cent or more of the total number of the issued shares or the total amount invested in a domestic corporation as of the date of the transaction in question;

(ii) Transactions between a related foreign company and its Korean parent company; this applies to a foreign corporation in which 50 per cent or more of the total number of issued shares or the total amount invested is directly or indirectly owned by a domestic corporation as of the date of the transaction in question.

III.2 Determination of transfer pricing

A. General standard

Transactions between the company in question and a related foreign company, that are not in compliance with arm's length pricing are subject to arm's length allocation. The term 'transfer price' is defined as the price used for the sale or purchase of inventory, supply of services or any transaction made by and between a corporation and a related foreign company. The term 'arm's length price' is defined as the market price computed using a method prescribed by ED-CTL Article 46(4), which is the price that would have been paid if the transaction was made between unrelated parties with respect to the same or similar type of inventory, service or any other under the same or similar circumstances as those transacted between the corporation and its related foreign company. Virtually all transactions associated with determining the income

earned by a corporation during the taxable year are subject to the transfer pricing regulations. The regulations apply to sale or purchase of inventory, supply of services, and ‘other transactions’.

B. Sale or purchase of inventory

The Korean Regulations apply to the inventory covered under ED-CTL Article 85(3), which include products, semi-finished products and stock in process, raw materials, and stored goods. Articles 7 through 9 of the Regulations contain the four methods for determining arm’s length prices to be applied to inventory, and each of them are explained in Notice 1990-4, containing examples of transactions regarding the transfer or purchase of inventory: 1) comparable uncontrolled price method; 2) resale price method; 3) cost plus method; 4) methods ‘deemed reasonable’. For the details of these four methods, see Appendix 1.

C. Use of tangible property

The Korean Regulations do not specifically regulate the use of tangibles, thereby applying the general rules for tangibles.⁶

D. Loans and advances

Notice 1990-4 provides that the methods applying to inventory also apply to the lending and borrowing of money and further provides that the arm's length price for loan transactions is the interest rate applied between unrelated parties for a transaction conducted in identical circumstances as the transaction in question. Factors such as the amount of loan, period, currency, market and credibility must be considered. Companies in the banking business whose main function is the lending of money will normally apply the comparable uncontrolled price method to calculate an arm's length price. If the comparable uncontrolled price is not available, one can calculate the arm's length price by adding the normal margin to the fund raising cost.

E. Services

Notice 1990-4 provides that the same methods that are applicable to inventory may also be used to determine the arm's length price for services. If there is an identical type of transaction in the same circumstance as that of the transaction at issue, the payment for the comparable transaction may be viewed as an arm's length price using the comparable uncontrolled method. If there is no comparable uncontrolled transaction, an appropriate markup ratio may be used in calculating an arm's length price and the cost plus method is used by adding the normal margin to the cost actually incurred for the services furnished. Notice 1990-4 provides rules for services such as management, administration, and technical services, that

accompanies the primary service furnished by a corporation whose main business in its transaction with its related foreign party is the supply of services. The payment for services furnished in a similar transaction conducted by unrelated parties will in such cases be adopted as the basis for calculating the transfer price for the service at issue. When the determination of the arm's length price under this method is difficult, factors such as expenses are to be used in the calculation and all the expenses incurred directly or indirectly are considered in determining the price for the transaction in question.

F. Intangibles

The Regulations apply to intangibles as defined in CTL Article 55(1)(9)(a) and (b), which include as intangibles copyright on academic and artistic work, movies, patent rights, trademark rights, designs, modes, drawings, secret formulas or processes, films or tapes of radio and television broadcasting and other similar assets or rights, information on industrial, commercial or scientific knowledge, experience or skills.⁷ While the Korean Regulations do not state which methods are to be used for intangibles, Notice 1990-4 provides that the methods that apply for tangible property are also to be used for intangibles. Therefore, the determination of transfer pricing for tangibles also generally apply to intangibles (comparable uncontrolled price method, resale price method, cost plus method, and catch-all method). However, the Regulations state that because in some cases it is difficult to find a comparable payment for determination of transfer pricing for the transfer of intangible properties, an alternative to the conventional

methods is to compare the activities of the corporation in question on a long term basis with the trend prevailing among unrelated parties carrying out the same or similar business activities. This approach is, in compliance with the OECD guidelines, only to be used if none of the conventional methods are applicable.

III.3 Burden of proof

ED-CTL Article 46(5) places the burden of proof on the taxpayer requiring the taxpayer to submit documents relating to transfer pricing. The taxpayer bears the total burden for establishing an arm's length price. The taxpayer must establish that the adjustment made by the NTA is arbitrary or unreasonable.⁸

III.4 Disclosure and compliance

A. Reporting requirements

Under the Korean transfer pricing rules, a corporation which has transacted with foreign related companies must submit to the tax office the following documents along with the corporate income tax return: 1) schedule detailing transactions with overseas related parties (Form No.59); 2) summarized income statement of overseas related companies (Form No.1); and 3) additional financial statements or supplementary schedules. For the details of there required documents, see

Appendix 2.

B. Sanctions against non-compliance of reporting requirements

In the case where a corporation in question has failed to submit the requested information and documents under the transfer pricing rules in a timely manner, the corporation can be subject to a detailed document analysis or a field tax audit. If the corporation in question included in the list of corporations subject to tax audit does not comply in a timely manner with the request to submit requested information and documents made in the course of conducting the tax audit, the Commissioner may make an arm's length allocation using one of the four methods which is considered most appropriate and may determine the taxable income and the tax liability of the corporation in question accordingly. The taxpayer may have the assessment reviewed by filing an appeal with the National Tax Tribunal or may challenge the assessment in court pursuant to the appealing procedures prescribed in the Basic Law Concerning National Tax.

IV. Taxation and income shifts of foreign multinational enterprises in Korea

This section attempts to examine the extent to which foreign invested firms in Korea are engaged in transfer pricing practices to avoid tax. Since our data and information are limited, so is our analysis. We investigate the behavior of foreign invested firms in Korea only because

we do not have relevant data for the practices of Korean invested firms abroad.

We first examine Korean tax system related to foreign direct investments to see whether there are systematic incentives for income shifts. Then the effective tax rates on foreign invested firms and domestic firms are compared. Finally, we attempt to investigate whether foreign invested firms shift income abroad to avoid tax by comparing the rates of return of foreign invested firms with those of domestic firms.

IV.1 Korean tax system related to foreign direct investments

Until the end of 1993 corporate income tax rate in Korea was 20 per cent for corporate income less than or equal to 100 million won and 34 per cent for those over 100 million won. The resident tax added to corporate income tax was 7.5 per cent of corporate income tax liability. Thus total tax burdens on corporate income were 21.5 per cent and 36.55 per cent, respectively. As of the first of January 1994, total tax burdens were decreased to 19.35 and 34.4 per cent, respectively, as corporate tax rates were reduced to 18 per cent and 32 per cent.

Capital gains are added to corporate profits in the calculation of corporate income tax. On top of that, the 'additional capital gains tax' is levied on capital gains from transactions of real estate of which rate is 25 per cent. Since Korean government restricted foreign investments in Korean real estate, there would be few foreign invested firms liable to the 'additional capital

gains tax’.

Firms which are not listed on the Korean Stock Exchange(KSE) should pay 25 per cent of retained earnings over 40 per cent of income as an excessive retained earnings tax. Majority of foreign invested firms are not listed on KSE and thus liable to the ‘excessive retained earnings tax’. Starting 1994, excessive retained earnings tax rate decreased to 15 per cent of the retained earnings over 50 per cent of income or over 10 per cent of capital, whichever is larger. The withholding tax rates on dividends are determined by tax treaty and generally in the range of 5-20 per cent. For dividends to non-treaty countries, the withholding tax rate is 20 per cent in general and 25 per cent for large share holders. The withholding tax rate for the dividends of the firms unlisted on the KSE is 25 per cent.

Furthermore, the property tax rate of 0.3 per cent⁹ and the tax on excessively increased value of land is imposed on the owner of an idle land. The tax on excessively increased value of land is not relevant to foreign investors or foreign invested firms because they are not allowed to own Korean land other than necessary for their business.

Table 10 shows the corporate tax rates and treatment of corporate capital gains of OECD countries in comparison with those of Korea. Corporate income tax rates of OECD countries are generally in the range of 30-50 per cent and the average is about 40 per cent. In most of OECD

Table 10 Taxing profits in OECD countries and Korea(1991)

Country	Corporation tax rate(%)	Treatment of corporate capital gains ⁴⁾	Net wealth taxes on corporations
Australia	39	C	-
Austria	39	C, D	1+0.5 surtax
Belgium ⁸⁾	39	C (holding less than 5 years), 19.5 % (more than 5 years), D	-
Canada ⁸⁾	41.74 (35.74) ¹⁾	75 % of value	0.2
Denmark	38	Generally exempt	-
Finland ⁸⁾	40.2	C ⁶⁾ , D	-
France	34 42 ³⁾	Less than 2 years 34 % More than 2 years 19 % or 25 % ⁵⁾	-
Germany	56.5 44.3 ³⁾	C, D	0.6
Greece	46(40) ²⁾	C	-
Iceland	45	C, D	1.45
Ireland	43(10) ¹⁾	Holding period Rate Less than 3 years 50 % 3-6 years 35 % More than 6 years 30 %, D	-
Italy	47.83	C	-
Japan ⁸⁾	49.98	C ⁶⁾	-
Luxembourg	39.39	C, D	0.5
Netherlands	35	C, D	-
New Zealand	33	Exempt	-
Norway	50.8	C, D	0.3
Portugal	39.6	C, D	-
Spain	35.34	C, D	-
Sweden	30	C	-
Switzerland	13.15-38.36	C ⁶⁾	0.439 ⁷⁾
Turkey	49.2	C, D	0.3-0.6
U.K. ⁸⁾	34	C, D	-
U.S. ⁸⁾	38.3	C, D	-
Korea	36.65	C ⁶⁾	0.3

- Note: 1) Figure in bracket is the tax rate on manufacturing industry.
2) 40 % applies where companies are quoted on the Athens stock market.
3) On distributed profits.
4) C = Taxed at corporation rate.
D = Tax deferred if reinvested.
5) Must be reinvested, otherwise 34 %.
6) Special Rates for real estate.
7) Rate for Zurich (federal, cantonal, municipal and church taxes).
8) These countries apply lower rates to corporations with profits below a certain threshold or to small businesses.
- Source: OECD, *Taxing Profits in a Global Economy*, 1991.
Kim, Yu Chan(1994)

countries, capital gains are taxed at the same rate as the corporate tax rate and the withholding tax on dividends are in the range of 5-20 per cent. Comparing these tax rates with those of Korea, we can say that Korean tax rates on corporate income is not significantly different from those of advanced countries.

Until 1983, 100 per cent of taxes on profits of foreign invested firms were exempted for 5 years and 50 per cent were exempted for additional 3 years. Therefore, Korea was in the group of low tax countries despite her high statutory tax rate. The scope and period of exemption were reduced in 1984 and in 1991 again.¹⁰ Currently, only the firms accompanying high technology or in free-trade zones are subject to tax exemption. Taxes are exempted fully for the first three years and by 50 per cent for another 2 years.

As a result of these changes in tax exemption policy, the ratio of tax exemption to total tax payments decreased gradually. The ratios of tax exemption to total tax payments of foreign invested firms were in the range of 80-90 per cent in 1982-1984 and about 40 per cent in the period of 1985-1987.¹¹ In the period of 1989-1991, tax exemption for foreign invested firms in manufacturing sectors was 78 billion won which was 9.2 per cent of their total tax payments, 848 billion won.

Since Korean statutory tax rates are at the similar level to those of high tax countries, foreign invested firms in Korea, especially from tax haven countries or tax exemption countries, seem to have incentives to shift income from Korea to the related companies in other low tax

countries.¹²

IV.2 Korean taxes paid by foreign invested firms

We obtained the data for foreign invested firms from the files for corporate income tax return of the NTA. The sample includes all foreign invested firms in manufacturing sector for the period of 1988-1991. The number of foreign invested firms in Korea in manufacturing sector were 1,115 in 1988, 1,247 in 1989, 1,332 in 1990, and 1,320 in 1991.

The data for domestic firms are from the various issues of *Financial Statement Analysis* published by the Bank of Korea. The data from *Financial Statement Analysis* represent those for all firms in Korea including both domestic and foreign invested firms. Since foreign invested firms in manufacturing sector account for only 2 per cent of firms in Korea in this sector, it may not be unreasonable to say that the data from *Financial Statement Analysis* represent domestic firms.

Table 11 compares taxes paid to Korean government by foreign invested firms and domestic firms in manufacturing sectors. The first 5 rows consist of taxable income and tax payments of foreign invested firms and the rest rows compare the effective tax rates for foreign invested firms with those for domestic firms. Since firms with deficits could carry over the deficits for 5 years, we should subtract net deficits carried over from net income of firms with positive income to calculate appropriate tax base. However, we do not have the data on deficits

carried over. Moreover, the only data we have for the income of domestic firms is the aggregate data which is the net of income for firms with positive income subtracted by the deficits of firms with deficits.¹³ Therefore, we assume that total income net of total deficits (which is shown as net combined income in Table 11) is the tax base. The effective tax rate on domestic firms estimated under the assumption was 40.91 per cent on average in the period of 1988-1991. The comparable effective tax rate for foreign invested firms, denoted by D/C in the table, was 41.24 per cent on average in the same period.

Table 11 The effective tax rates

unit: billion won, %

		1988	1989	1990	1991	1988-1991 ¹⁾
Foreign invested firms	Net income of firms with positive income(A)	1,126.4	1,078.8	1,635.0	1,250.8	5,091.0
	Net deficits of firms with deficits(B)	227.1	378.9	912.9	828.7	2,347.6
	Net combined income (C=A-B)	899.3	699.9	722.1	422.1	2,743.4 (1,844.1)
	Tax payments(D)	283.2	249.8	274.3	324.0	1,131.3 (848.1)
	Tax exemption(E)	N.A	24.8	27.9	25.2	(77.9)
	D/C(%)	31.49	35.70	37.99	76.76	41.24
Domestic firms	Tax payments/Net combined income(%)	40.05	42.93	42.09	39.00	40.91

Note: 1) The numbers in the brackets are for 1989-1991.

Source: The data base of the NTA

The Bank of Korea, *Financial Statement Analysis*, various issues.

The 'additional capital gains tax' related to real property sales, which is about 2.5 per

cent of the tax base for domestic firms under our assumption¹⁴, is not relevant to foreign invested firms. Moreover, some foreign invested firms still receive the benefit of tax exemption which was equivalent to 4.2 per cent of the tax base in 1989-1991. Taking these two factors into account, we can say that the estimated effective tax rate for foreign invested firms should be lower than those for the domestic firms by about 7 per cent. However, Table 11 suggests that the effective tax rates for foreign invested firms were higher than those for domestic firms.

One of the reasons why the estimated effective tax rate for foreign invested firms were greater than those for domestic firms could be that the portion of firms with deficits was greater for foreign invested firms than for domestic firms. As we mentioned above, deficits can be carried over for 5 years. Thus, the long-term effective tax rate would not be affected by deficits if all the deficits were carried over. However, deficits of a firm could continue for 2 or 3 years and in many cases profits the firm could get after 2 or 3 years' deficits may not be large enough to counterbalance all the deficits of previous years. For domestic firms, actual deficits carried over for 5 years from 1987 were 3,328 billion won which accounted for only 22.2 per cent of net deficits of the firms with deficits in the same period.

When we apply the ratio of deficits carried over for all firms in Korea, 22.2 per cent, to both domestic firms and foreign invested firms in manufacturing sector, we find that the effective tax rates calculated under our assumption was overestimated by 16 per cent for foreign invested firms and by 8 per cent for domestic firms. The adjusted effective tax rates would be about 25 per cent and 33 per cent, respectively. The difference of 8 per cent is in line with the expected

difference of 7 per cent we mentioned above. This is shown in Table 12.

Table 12 Adjusted effective tax rates (1988-1991)

	unit: billion won, %	
	Foreign invested firms	Domestic firms
Combined net income(A)	2,743.4	14,903.6
Net deficits for firms with deficits(B)	2,347.6	4,428.2 ¹⁾
Net income for firms with positive income(C)	5,091.0	19,331.8 ¹⁾
Deficits carried over(D)	520.6 ²⁾	982.1 ²⁾
Adjusted taxable income (E=C-D)	4,570.4	18,349.7
Tax payments(F)	1,131.3	6,096.5
Adjusted effective tax rate(G=F/E, %)	24.8	33.2

Note: 1) Calculated under the assumption that the ratio of net deficits for firms with deficits(B) to net income for firms with positive income(C) is 22.9 % which is the deficits/income ratio of domestic firms in all sectors.

2) The ratio of deficits carried over to deficits of all domestic firms in all industrial sectors equally to foreign invested firms and domestic firms in manufacturing sectors.

Source: The same as those of Table 11.

This suggests that Korean government provide equal tax application for foreign invested firms with domestic firms except for the tax exemption. In fact, the Korean tax law does not differentiate tax treatments to foreign invested firms from those to domestic firms.

Now we may look whether the reported taxable income of foreign invested firms are in line with those of domestic firms. Table 13 compares the tax payments of foreign invested firms with their total sales and capital. This table suggests that domestic firms pay significantly more taxes than foreign invested firms in light of their sales volume or capital size. Even taking the tax exemption for foreign invested firms and the additional capital gains tax which is not relevant to foreign invested firms into consideration (they accounted for 0.07 per cent point and 0.06 per cent point, respectively), foreign invested firms pay less taxes than domestic firms by 0.14 per cent of sales or 0.12 per cent of assets due to their low rates of return. This is mainly because foreign invested firms' reported net income was lower than those of domestic firms.

Table 13 Tax payments, total sales, and total assets

unit: billion won, %

		1988	1989	1990	1991	1988-1991
Foreign invested firms	Tax(A)	283.2	249.8	274.3	324.0	1,131.3
	Exemption(B)		24.8	27.9	25.2	77.9 ¹⁾
	Sales(C)	28,465.8	30,563.7	37,010.0	44,450.4	140,489.9
	Assets(D)	24,478.7	29,389.9	39,126.6	49,221.2	142,216.4
	A/C(%)	0.99	0.82	0.74	0.73	0.81
	A/D(%)	1.16	0.85	0.70	0.66	0.80
	B/C(%)		0.08	0.08	0.06	0.07 ¹⁾
	B/D(%)		0.08	0.07	0.05	0.07 ¹⁾
Domestic firms	Tax/Sales(%)	1.34	1.19	1.02	0.88	1.08
	Tax/Assets(%)	1.52	1.18	0.97	0.81	1.05

Note: 1) 1989-1991

Source: The same as those of Table 11.

IV.3 Profit rate of foreign invested firms

For the analysis of transfer pricing manipulation for tax evasion, one should investigate the relationship of multinational corporations' income from each country to the differences in tax rates. But we do not have the data for the income of foreign multinationals in Korea by the country of source. Thus, we just compare the profit rates for foreign invested firms in Korea with those of domestic firms.

A. Profit rate of foreign invested firms by foreign investors' share

We divide foreign invested firms in Korea into three groups depending on their share of ownership. The first is the group of firms whose foreign investors' share is above 70 per cent.¹⁵ The second is the group of firms whose foreign investors' shares are between 40 per cent and 70 per cent.¹⁶ And the third group is the group of firms in which foreign investors cannot lead decision making because their shares are low. This group includes the firms with foreign investors share 40 per cent or lower. It may be more reasonable to divide the second group into those with foreigners' share 50 per cent or over 50 per cent and others. But we formed a group of firms whose foreign investors' share are around 50 per cent together because the incentives for transfer pricing in this group of firms would not be strong as the domestic and foreign investors' interests are almost balanced.

Table 14 shows the features of foreign invested firms in each group. The number of foreign invested firms in Korea in 1991 was 1,320; 277 firms in the first group, 668 firms in the second group, and 375 firms in the third group. The first group mainly consists of the firms whose foreign investors' shares are 100 per cent or close to 100 per cent. The firms with foreign investors' share over 90 per cent were three quarters of those in this group and the average foreign investors' share was 93.44 per cent. The average foreign investors' share of the second group was 50.38 per cent and those whose foreign investors' share is in the range of 45-55 per cent were 571 firms accounting for 81 per cent of total 668 firms in this group. Foreign investors' shares of the firms in the third group were spread evenly within the range of 0-40 per cent. The table also suggests that the smaller the foreign investors' share, the larger is the firm size.

Table 14 Features of foreign invested firms in manufacturing sector(1991)

Foreign investors' share(R)	Group A (R > 70)	Group B (70% ≥ R > 40%)	Group C (40% ≥ R > 0%)	Total
Number of firms	277	668	375	1,320
Average of foreign investors' share(%)	93.44	50.38	17.35	42.85
Total assets per firm (10 billion won)	10.85	23.84	80.76	37.28
Total sales per firm (10 billion won)	11.97	20.50	73.15	33.67

Source: The data base of National Tax Authority.

Table 15 compares profit/sales and profit/asset ratios of foreign invested firms in each group with those of domestic firms and Figure 1.a-1.c in Appendix 3 plot the trends of profit/sales ratios. The average profit rates for foreign invested firms in Korea were lower than domestic firms with difference of 0.3-0.7 per cent.

Table 15 Profits rates of foreign invested firms by foreign investors' share

unit: %

			1988	1989	1990	1991
Profit/ Sales	Foreign invested firms ¹⁾	Group A (93.4 %)	2.07	0.56	2.68	4.79
		Group B (50.4 %)	7.00	6.28	6.68	5.92
		Group C (17.4 %)	6.28	5.61	6.35	5.87
		Average	6.04	5.36	6.16	5.80
	Domestic firms	6.82	6.02	6.50	6.56	
Profit/ Assets	Foreign invested firms ¹⁾	Group A (93.4 %)	3.09	0.78	3.19	5.29
		Group B (50.4 %)	8.06	6.31	6.08	5.10
		Group C (17.4 %)	7.04	5.72	5.97	5.31
		Average	7.02	5.58	5.83	5.24
	Domestic firms	7.73	5.93	6.13	5.98	

Note: 1) Numbers in the brackets are the average foreign investors' shares in each group.
Source: The same as those of Table 11.

A notable thing here is that foreign invested firms in the first group exhibited significantly

low profit rates (Figure 1 of Appendix 3). In three out of four years, they were less than a half of domestic firms' profit rates. On the other hand, the profit rates of foreign invested firms in the other two groups did not show big differences from those of domestic firms. The profit/sales ratio of those two groups were in the range of 5.61-7.00 per cent.

According to Table 15, one may suspect that foreign invested firms in the first group are shifting their income from Korea to other countries through transfer pricing. Compared to those in the other two groups, the firms in the first group are in the strongest position to shift their income to other countries. However, besides transfer pricing, the following factors might have affected the profit rates of foreign invested firms in the first group. First, foreign invested firms with low foreigners' share are mainly joint investments with large domestic corporations while foreign invested firms with higher foreigners' share are relatively small in their size. The profit/sales ratios of domestic firms in manufacturing sector were 6.18-7.20 per cent for large corporations in the period of 1989-1991 while those for small and medium domestic enterprises were 4.37-5.85 per cent in the same period (Table 16).

Another reason for low profitability of the first group may be the deteriorated profitability of export-oriented firms in recent years. Previously Korean government strictly controlled foreign investors' share of foreign invested firms. For example, in 1970's 100 per cent foreign invested firms were allowed on the condition that they should export all their products from Korea. Consequently, most of foreign invested firms in the first group were cheap-labor-seeking export-oriented investments. Export-oriented enterprises showed profit rates of 4.76 per cent and 5.43

per cent in 1989 and 1990 while those of local-market-oriented enterprises were 6.63 per cent and 6.89 per cent, respectively. In 1991, the profit rate of export-oriented enterprises was a little bit higher than that of local-market-oriented firms. This may partly explain the fact that the profit rate of the firms in the first group in 1991 is higher than those of previous years.¹⁷

Table 16 Profit/Sales for domestic firms

	unit: %		
	1989	1990	1991
Manufacturing industries			
Large enterprises	6.18	6.73	7.20
Small and medium enterprises	5.47	5.85	4.73
All industries			
Export-oriented enterprises ¹⁾	4.76	5.43	6.62
Local-market-oriented enterprises ²⁾	6.63	6.89	6.54

Note: 1) Firms with export/sales ratio 50 % or greater than 50 %.

2) Firms with export/sales ratio less than 50 %.

Source: The Bank of Korea, *Financial Statement Analysis*, various issues.

However, these factors still do not seem to fully explain the low profit rates of the firms in the first group. Perhaps transfer pricing manipulation could be another important factor. But we do not have any direct evidence.

Table 17 and Figure 2.a-2.d in Appendix 3 compare the profit/sales ratios of the firms in the first group in major manufacturing sectors with those of domestic firms.¹⁸ The table

suggests that the low rates of return for foreign invested firms in the first group are mainly due to the low profit rates of textile, wearing apparel, and leather and machinery industry. Especially, the low profit rate of machinery industry which accounts for about 58 per cent of the number of the firms and 72 per cent of the sales of foreign invested firms in the first group seems to be the main reason of the substantially low profit rate of the firms in the first group.

Table 17 Profit rates of foreign invested firms by industrial sector(1988-1991)

unit: %

Industrial sector	Foreign invested firms				Domestic firms (average profit rate)
	Average profit rate		Share of firms in group A		
	All	Firms in group A	Number (1991)	Sales (1988-1991)	
Food & beverages	4.8843	5.7484	7.9	8.3	5.2492
Textiles, wearing apparel & leather	6.1084	0.2747	7.6	2.6	4.7640
Chemicals, petroleum, coal, rubber & plastics	6.6518	6.2436	15.5	6.6	7.5021
Machinery	5.3121	1.6445	58.1	72.2	6.3264
Manufacturing	5.8491	2.6100	100.0	100.0	6.4825

Source: The same as those of Table 11.

In general, transfer pricing is more relevant to technology and human capital intensive industries such as general machinery, electric and electronic product, and transport machinery than to other sectors. Since these sectors are R&D intensive, they have more flexibility in

applying the R&D cost to the price of their products. Moreover, most of the parts are order-made and are not standardized. Therefore, it is difficult to get the arm's length price. Intra-firm transactions of the U.S. and Japanese multinational enterprises which account for about 70 per cent of FDIK are concentrated in these sectors than in other sectors.¹⁹

A number of foreign invested firms in machinery industry get tax exemption. In the period of 1989-1991, 56 billion won of tax were exempted for machinery industry accounting for 72 per cent of total tax exemption in manufacturing sectors. A half of tax exemption for machinery industry is for the firms in the first group while in its number, the first group accounted for only 24 per cent of foreign invested firms in machinery industry. The tax exemption seem to have reduced incentives for income shift from Korea to other low-tax countries. This is supported by the fact that many firms in Group A and in machinery industry showed profit rates over 10 per cent in the period of 1988-1991. In spite of this, the average profit rate of foreign invested firms in the first group of machinery sector is substantially lower than the average of foreign invested firms and of domestic firms in this sector. This suggests that many foreign invested firms in machinery industry whose taxes were not exempted or exemption period was over might have abused transfer pricing practices. The firms in the first group and in machinery industry showed average profit rate 1.64 per cent in the period of 1988-1991 while the average profit rate of foreign invested firms in this sector was 5.31 per cent and that of domestic firms was 6.33 per cent.

IV.4 Tax system of the home country and income transfer

The benefit from transfer pricing depends on the tax system of the home country. First, income shift from high tax country to low tax country increases the limit of foreign tax credit when the firm has an excess credit and thereby raise after-tax global profit if the home country provides worldwide credit like the U.S. and Japan.²⁰ If the home country provides credit by source like the U.K., the income from low tax country cannot counterbalance excess credit from high tax countries. Thus, a multinational corporation from a credit-by-source country would not have an incentive to transfer income from Korea to a low tax rate country as long as the home tax rate is higher than the Korean tax rate. Second, countries providing worldwide credit generally tax earnings from foreign subsidiaries only when they are repatriated. Therefore, by shifting income from high tax country to low tax country a multinational firm can defer home tax as long as the income is retained in foreign subsidiaries. In the meantime, by deferring tax firms can get interest income. Third, if the home country provides tax exemption for foreign source income, a multinational corporation can reduce total tax liability through income shift from Korea to any lower tax country. Fourth, if the tax rate of the home country is lower than that of the host country, a multinational corporation can save a part of tax by shifting income from the affiliates in high tax country to the home country irrespective of the home country provisions alleviating international double taxation.

Therefore, we can conclude that a multinational corporation whose home country is a low tax country or provides tax exemption for foreign source income can get the largest benefit from

shifting Korean income to other low tax countries. The next are those whose home countries provide worldwide credit. The firms from countries providing worldwide credit can get two different types of benefits from income shifting. One is the saving of tax on branch income or income repatriated from foreign subsidiaries to the parents when the firms have excess credit. The other is the benefit from the deferral of home tax on foreign source income. The firms whose home countries provide credit by source could not get benefit from transferring their Korean income to other low tax countries if the home tax rate is higher than that of Korea.

Table 18 and Figure 3.a-3.d in Appendix 3 provide the average and trends of profit rates for foreign invested firms in Korea with foreign investors' share 50 per cent or more by the tax system of the home country.²¹ The low tax countries in the table consist of the countries whose tax rates are substantially lower than that of Korea. The countries in the other three groups have tax rates close to or higher than that of Korea. The firms from the countries providing credit by source showed the highest average profit rate. The next are those from the worldwide credit countries. The third are those from the tax exemption countries. Table 18 shows that the firms from the low tax countries exhibited the lowest profit rates. These results supports the argument that a multinational corporation from the country providing credit by source cannot get anything from shifting income from Korea to other low tax countries while multinational corporations from tax exemption countries or low tax countries get the largest benefit from income shifting.

One of the notable findings from the table is that the rates of return for multinational corporations from low tax countries are substantially lower than those from tax exemption

countries. This might be explained partly by the following three factors. First, a multinational corporation from a tax exemption country can save tax on foreign source income only when it has at least one other related company in a lower tax host country while those from the low tax countries can save tax by shifting income directly to the parent in the home country. Therefore, income shifts may be greater for the firms from the low tax countries than for those from tax exemption countries. Second, a multinational corporation from a tax exemption country might have an incentive to transfer income from the parent to the subsidiary if the home tax rate were higher than that of the host country. This incentive might raise the average profit rate of multinational corporations from tax exemption countries while the incentive to transfer income from Korea to a low tax host country might reduce the average profit rate of those corporations. Third, a considerable portion of foreign investments in Korea originated from the low tax countries were realized in recent years. In many cases, firms cannot get positive profits for the first few years from their establishments.

Table 18 Profit rates of foreign invested firms by the tax system of the home country
(1988-1991)

unit: %

Tax system of the home country		Number of firms (1991)	Profit/Sales	Profit/Assets
High tax countries	Credit by source	22	9.1714	7.8576
	Worldwide credit	459	5.7631	5.5402
	Tax exemption	69	5.6981	3.3674
Low tax countries		22	1.4881	2.2827
Domestic firms			6.4825	6.3061

Source: The same as those of Table 11.

V. Summary and concluding remarks

The Korean tax authorities started to pay attention to transfer pricing in the middle of 1980's as it gradually deregulated the foreign direct investment flows. The government revised corporate tax law to adopt transfer pricing rules in 1988. The rules can be applied to both foreign invested firms in Korea and Korean invested firms abroad. The new law and the following internal guidelines for the enforcement of transfer pricing rules not only provides the methods commonly used to determine the arm's length price but also contains provisions mandating disclosure of information. Korean transfer pricing rules are founded squarely on the generally accepted rules recommended by OECD. Furthermore, Korean tax authorities has been very cautious in applying transfer pricing regulation on foreign invested firms.

Korean tax law still provides hundred percent of tax exemption for the income from foreign investments accompanied by high technology or those in free-export zone for three years and a half of it for additional two years. Korean law does not discriminate foreign invested firms from domestically owned firms in the matter of taxation of reported income otherwise. Our analysis of data suggests that, excluding the tax exemption, the effective tax rates on reported income do not show significant differences between foreign invested firms and domestic firms. However, it also suggests that Korean government may be losing some tax revenue from foreign invested firms because of their low reported income.

The average reported profit rate of foreign invested firms has been somewhat lower than

that of domestic firms. This low rate of return might have caused the loss of Korean tax revenue which amounts to about 0.14 per cent of the sales of foreign invested firms. Among foreign invested firms, the average profit rate of those of which foreign investors' shares are over 70 per cent (the average foreigner's share in this group was 93.4 per cent) has been significantly lower than that of domestic firms. However, this in itself cannot be taken as a direct evidence for transfer pricing abuse for the tax avoidance. Since, besides transfer pricing manipulation, other factors may have also affected the low rate of return for the firms with high foreign investors' share. Those are: (1) Foreign invested firms with high foreigners' share are small in their size while those firms with relatively low foreigners' share are mostly joint venture with large Korean companies whose rates of return are relatively high. (2) Many of foreign invested firms with high foreigners' share are export-oriented firms whose profitability decreased in recent years. Nevertheless, we found those two factors could not fully explain the low profit rate of those firms, which suggests that transfer pricing may have been part of the reason.

As for the tax system of the home country, the rate of return of the firms from the countries with the tax system which gives credit by source showed the highest profit rate and the firms from low tax countries exhibited substantially low rate of return. The average profit rate of the firms from tax exemption countries is somewhat lower than that of those from worldwide credit countries. This also suggests that there could have been some moderate degree of transfer pricing of foreign invested firms.

With respect to the implication of transfer pricing regulation for the flows of FDIs, it

seems to be too early to draw any implication. The transfer pricing regulation in Korea has been effective only since 1989 and there have been only a handful of cases to which the regulation has been applied. The recent decline of foreign direct investment inflows is mostly due to aggravated domestic environment rather than transfer pricing regulations. Since the strict application of the transfer pricing regulations could cause frictions with other countries about taxing power over the multinationals and have negative impacts on inflows of foreign investments, Korean authorities have been cautious in applying the rules.

However, the analyses in this paper may provide a few implications for the future development of transfer pricing regulations in Korea. The results of this paper suggest that a part of foreign invested firms are engaged in the practice of transfer pricing and therefore Korean government may be losing a part of its tax revenue. However, we can hardly say that transfer pricing practice is a phenomenon widespread to most of foreign invested firms in Korea. It is rather prevalent only to those with certain characters such as high foreign investors' share and in some industrial sectors. Therefore, although the government should protect its taxing power and carefully monitor transfer pricing practices of foreign invested firms with certain criteria, it should avoid imposing burdensome compliance requirements to foreign invested firms in general. In developing comparable standards by transaction type and by pricing method, the government should put more efforts to develop specific standards for some industrial sectors in which firms might have more incentives for transfer pricing. For foreign invested firms in other sectors, the government may encourage advanced pricing agreements and thereby reduce their future burden of documentation.

A foreign invested firm with profit rate substantially lower than the average of domestic firms in a very similar business environment could be suspected for transfer pricing manipulation on a fair ground. However, Korean and other governments should be careful in applying comparable profit method as the fourth method of determining the arm's length price. As we have shown in the case of foreign invested firms in Korea, there are some factors other than transfer pricing manipulation which affect the differences in the profit rates of foreign invested firms and domestic firms. Therefore, the government should not determine the amount of income shift through transfer pricing based only on the differences in the profit rates.

As the Korean government is expected to reinforce effort to induce foreign direct investment, it is also expected that its policies toward foreign multinationals, including transfer pricing regulation, would become more friendly.

Notes

1. For example, Japan introduced the regulation on transfer pricing in 1986.
2. For the details of Korean policy on FDIs, see Yu(1992).
3. (net capital inflows)= (total inflows)-(withdrawals or repayments of the principal)
4. See Weizman(1992) for detailed description of Korean transfer pricing regulations in comparison with U.S. regulations.
5. ED-CTL Article 46(1)

6. This perhaps implies that general rules for tangibles, i.e, the rent should be what unrelated parties would determine in similar circumstance, would be applied for the use of tangibles.
7. Deduction for royalties paid to foreign related parties are allowed in Korea(CTL Article 16).
8. This standard is yet to be tested by the Korean courts.
9. Different tax rates are applied to the property in several urban areas.
10. For the details of changes in the tax exemption policy, refer Yu(1992).
11. This includes all industrial sectors. The data for the tax exemption in the 1980's are from Lee(1991).
12. The statutory tax rate is more relevant to the investigation of income shifts than the effective tax rate. This is because given the level of investments, tax saving from transfer pricing is determined by the difference of the statutory tax rates rather than the effective tax rates which reflect investment incentives as well as the statutory tax rate. For the incentives for foreign invested firms to manipulate transfer price see Section IV.4 of this paper.
13. The deficits occurred in the same period as that in which the income has been obtained.
14. The assumption that the income subtracted by deficits is the tax base.
15. In most of firms in this group, foreigners' share is close to 100% and foreign investors are supposed to dominate the decision makings.
16. In this group, the foreign and domestic investors have almost equal shares and each side may not make unilateral decision on company matters.
17. There might be another explanation for the low profitability of foreign invested firms. Group A of Table 15 may have more new entrants than the other two groups of foreign invested firms and domestic firms do. This is because except for certain cases, the government allowed 100 per cent foreign ownership only in recent years. The profit rates of new entrants are low in general. But we do not have any empirical evidence for this. The possibility that foreign invested firms may be less mature than domestic firms was pointed out by Jeffrey Owens of OECD.
18. The manufacturing sectors in the table are those with more than 15 firms in the first group in 1991.
19. OECD(1993a).
20. This tax saving effect of income shift is relevant only to the subsidiary income repatriated to the parents and the branch income.
21. The appropriate data for the firms in Group A are not available.

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Appendix 1. Four methods determining the arm's length price

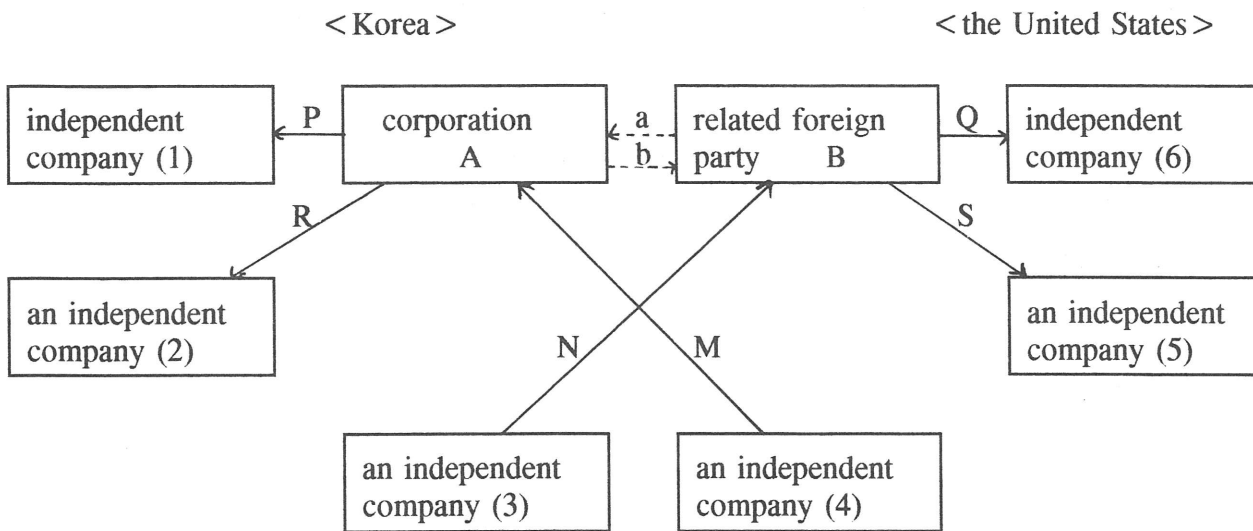
A. Comparable uncontrolled price method

The comparable uncontrolled price method under the Korean rules is similar to the OECD's 1979 recommendation. The arm's length price is defined under Notice 1990-4 as the price that should be prevailing if goods identical or similar to those in question were traded between independent uncontrolled persons under similar circumstances. All of the following three requirements must be met for a transaction to be comparable with a transaction subject to transfer pricing adjustment: 1) the transaction must be between independent unrelated parties, between the company in question or a related foreign company and a third party, or between two independent third parties; 2) the tangibles to the compared must be identical or similar to the ones at issue; and 3) the circumstances in which the independent uncontrolled parties are dealing must be similar to those in which the Korean company trades with a related foreign company. In case there is a difference between the transaction at issue and a comparable transaction which can be quantified, the adjustment of the price difference is the price reached after quantifying the price difference, which is then considered the arm's length price.

B. Resale price method

Transfer pricing under the resale price method is computed by subtracting an appropriate

markup amount from the price that a related company receives from an independent third party. Notice 1990-4 and Article 8 of the Regulations contain the following formula for calculating arm's length price under this method: 1) The appropriate markup amount, which is defined under Article 22(2) Item 2 of the ED-CTL, and if the corporation in question engages in a transaction with a related foreign company, then the appropriate markup amount is computed by multiplying the price which the foreign related company resells the tangible property to an unrelated party by an appropriate markup ratio; 2) The appropriate markup ratio, which is the amount computed as if the related purchaser in the transaction in question, or an unrelated party engaged in the same or similar business as the purchaser, was to purchase the same or similar property as the property in question from an unrelated party and resells it to another unrelated party during the taxable year in which the date of the transaction in question falls. The appropriate markup ratio is the normal profit rate calculated by adding up the sales prices of the property traded during a specific period of time. In determining the proper length of time which will be the basis for determining the scope of transactions for calculating a normal profit rate, the period of time may be a quarter, half a year or a full year, whatever falls closest to the date on which the transaction in question takes place; and 3) Arm's length adjustment, provided there are differences between the actual transaction and the comparable transaction in terms of functions performed by the seller, then the differences will be adequately adjusted in calculating the normal profit rate. The rules are illustrated in Notice 1990-4 by the following example.



Corporation A in Korea imports and exports inventory to a related United States corporation B, a wholly owned subsidiary, at the price of 'a' and 'b' respectively. Corporation A sells the same inventory to an unrelated Korean party (1) at the price of P. Corporation B resells the same inventory to an unrelated United States party (6) at the price of Q. Corporation A imports the identical or similar inventory from an unrelated United States party (4) at the price of M. An unrelated Korean party (3) exports the identical or similar inventory to B at the price of N. Corporation A sells the identical or similar inventory to an unrelated Korean party (2) at the price of R, and B sells the identical or similar inventory to an unrelated United States party (5) at the price of S. If the function assumed by corporation A and B in purchasing or selling the inventory in question are not different from those of the purchaser in the comparable transaction, and the circumstances of the transactions of corporation A and B are similar to those of the comparable transaction, the arm's length price of the inventory which corporation A exported to B is calculated as set forth below (1), and the arm's length price for the inventory

which corporation B exported to A is calculated as set forth below (2).

$$\begin{aligned} \text{(1) arm's length price} &= Q - \text{appropriate markup amount} \\ \text{appropriate markup amount} &= Q * \text{appropriate markup ratio} \\ \text{appropriate markup ratio} &= \frac{S-N}{S} \end{aligned}$$

$$\begin{aligned} \text{(2) arm's length price} &= P - \text{appropriate markup amount} \\ \text{appropriate markup amount} &= P * \text{appropriate markup ratio} \\ \text{appropriate markup ratio} &= \frac{R-M}{R} \end{aligned}$$

C. Cost plus method

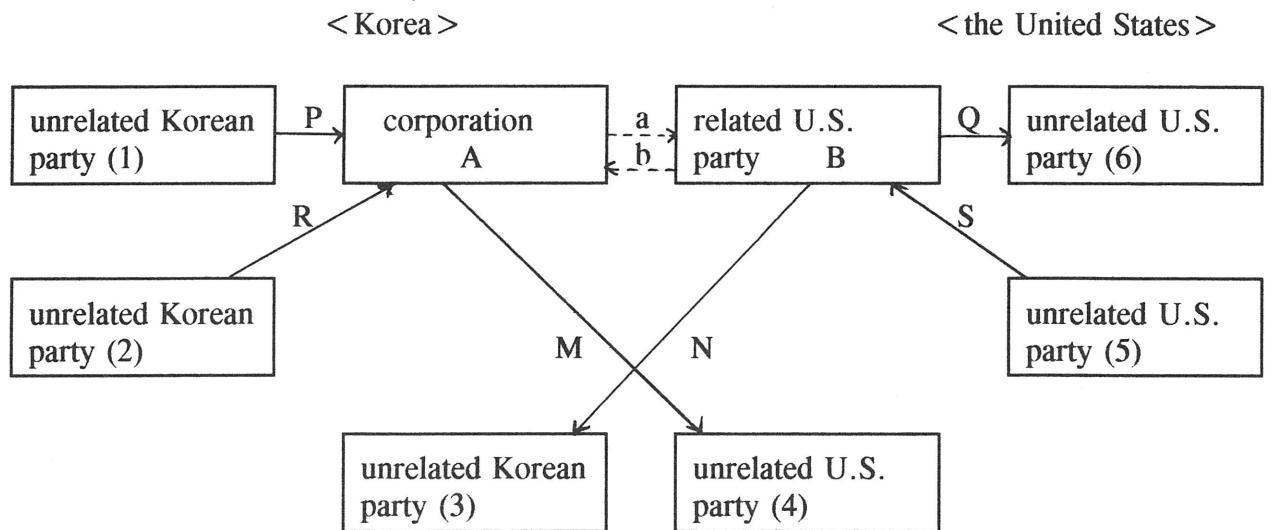
Transfer pricing under the cost plus method is determined by adding an appropriate mark-up amount to the cost actually incurred by the supplier purchasing products from an unrelated foreign party or manufacturing tangible property to sell the same property to a related company. Determination of transfer pricing under resale price method begins with price method which focusses on the purchaser, while the cost plus method focusses on the seller in question. The resale price method is used in cases where the purchaser's resale price for the property is known, while seller's purchase price for the raw material is not known. In contrast, the cost plus method is used in cases where the seller's purchase price is known, while the sales price of the purchaser is not known. The cost plus method is based on the following formula:

1) The appropriate markup amount, which is defined in Article 22(2), Item 3 of the Korean

Regulations, and is used in cases where the corporation in question is engaged in transactions with a related foreign company and where the seller in the transaction has acquired the property in question through purchase or manufacturing, the appropriate markup amount is computed by multiplying the costs incurred to purchase or manufacture the property by the appropriate markup ratio;

2) The appropriate markup ratio, which is used in cases where the seller in the transaction in question and an unrelated party engaged in a similar business acquired the same or similar property as the property in question through purchase or manufacturing, and sells it to an unrelated party for arm's length price, then the appropriate markup ratio is the ratio of the total sales profit to the total acquisition costs; and

3) Arm's length adjustment, applied to compute an appropriate markup ratio under the cost plus method, differences in factors such as the functions performed by the purchaser between the actual transaction and the comparable transaction should be adjusted. The cost plus method is generally to be used where the seller's purchase price is appropriate. If the seller in the transaction has purchased the property in question below the arm's length price, the purchase price cannot be used as the acquisition cost in calculating the appropriate markup amount to be used to determine transfer pricing under the cost plus method. Instead, the purchase price shall be adjusted to reflect the arm's length price as calculated under the comparable uncontrolled price method, as prescribed by ED-CTL Article 22(2). The rules are illustrated in Notice 1990-4 by the following example.



Corporation A in Korea exports at the price of 'a' and imports at the price of 'b' with related foreign party B. Corporation A purchased the inventory at issue from an unrelated party (1) at the price of P. Corporation A sold the inventory identical with or similar to that at issue to an unrelated United States party (4) at the price of M. An unrelated Korean party (3) imported from corporation B at the price of N. Corporation A purchased the inventory identical with or similar to that at issue from an unrelated Korea party (2) at the price of R. Corporation B purchased the inventory identical with or similar to that at issue from an unrelated United States party (5) at the price of S. Assuming that the functions assumed by corporation A and B and the circumstances of their transactions are no different from the counterparts of the comparable transaction, the arm's length price of 'a' at which corporation A exports to B is calculated as set forth below (1) and the arm's length price of 'b' at which corporation A imports from B is calculated as set forth below (2).

$$\begin{aligned}
 (1) \text{ arm's length price} &= P + \text{appropriate markup amount} \\
 \text{appropriate markup amount} &= P * \text{appropriate markup ratio} \\
 & \quad \text{M-R} \\
 \text{appropriate markup ratio} &= \frac{\text{---}}{\text{R}}
 \end{aligned}$$

$$\begin{aligned}
 (2) \text{ arm's length price} &= Q + \text{appropriate markup amount} \\
 \text{appropriate markup amount} &= Q * \text{appropriate markup ratio} \\
 & \quad \text{N-S} \\
 \text{appropriate markup ratio} &= \frac{\text{---}}{\text{S}}
 \end{aligned}$$

D. The catch-all method

The 'other methods that are deemed reasonable' are methods that may be applied in determining an arm's length price when it is considered impossible or unreasonable to use the comparable uncontrolled price, resale price or cost plus methods. The use of the catch-all method provide two methods which are 'deemed reasonable' in determining transfer pricing.

Method 1

The first method is related to the three conventional methods. Under the resale price method, the determination of transfer pricing is computed by subtracting an appropriate markup amount from the resale price of the property sold to an unrelated party. Similarly, where the property in question had been purchased from a related party and is resold to an unrelated party

through another related party, the transfer price may be computed by calculating backward from the price at which the good was sold to the final unrelated party. This method of calculating backward from the final price to arrive at an arm's length price is somewhat similar to the comparable uncontrolled price method, resale method and cost plus method combined in calculating the arm's length price as long as this method is found sufficiently appropriate.

Method 2

The second method is related to the allocation of income between the corporation and its related foreign party in proportion to the contribution to the income realized. Under this method, the allocation of income arising from a transaction between the corporation in question and its related foreign company, the following factors are considered: 1) the amount of cost and expenses accrued in connection with purchasing, manufacturing, or constructing products traded between the two related companies; 2) the value of fixed assets used in manufacturing, or constructing products traded between the two related companies; and 3) other factors that may be reasonably used in measuring the contribution to the income realized. The criteria for the allocation of income between the corporation in question and its related foreign corporation is dependent upon the business in which the parties are engaged.

Appendix 2. Reporting requirements for foreign invested firms in Korea

A. Schedule detailing transactions with related companies

Certain Korean subsidiaries and permanent establishments of foreign corporations are required under Article 11 of the Regulations to submit Form No.59, entitled 'Schedule detailing transaction with overseas related parties', when filing the annual corporate tax return. The requirement applies only to transactions with 'related parties'. Transnational transactions with foreign related parties to be included in form No.59 as attached to the tax return are the following: Receipt Transactions: 1) selling of inventories; 2) selling of other tangible property; 3) selling of intangible assets and transfer of licenses; 4) receipt of interest; 5) receipt of service charges; and 6) other. Payment Transactions: 1) purchase of inventories; 2) purchase of other tangible properties; 3) acquisition and use of intangible assets; 4) payment of interest; 5) payment of service charges; and 6) others.

B. Summarized income statement of foreign related companies

If, at the end of the taxable year, transactions among the corporation in question and each of its overseas related companies totals five billions won or more, including the receipt and payment transactions, then the corporation is required to submit a summarized income statement of the three foreign related companies which are the highest related in terms of transaction

amount. The summarized income statement must be in accordance with the financial accounting standards of Korea. The conversion of documentation is burdensome, and in practice, a simple reclassification of the accounts may be adopted. However, a Korean establishment of a foreign corporation will only be required to submit a summarized income statement for the foreign corporations which have direct or indirect ownership relationship with the foreign parent corporation, if the amount of transaction falls within the highest three amounts. In addition, a copy of the most recent annual report of concerned foreign related companies shall also be attached to the corporation income tax return.

C. Financial statements or supplementary schedules of related companies

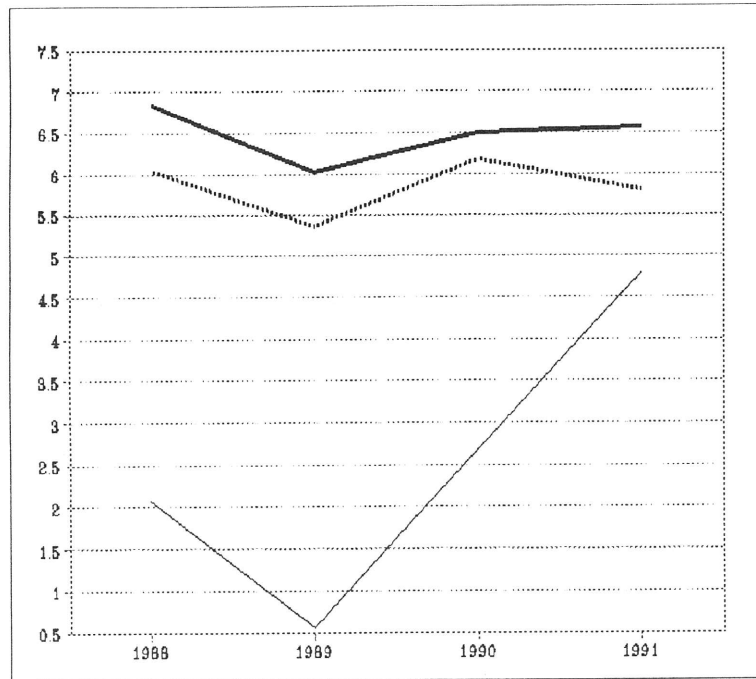
In addition, a domestic corporation, having a foreign subsidiary in which the corporation owns 50 per cent or more of total outstanding shares directly or indirectly of a foreign branch is required to submit the following documents at the time of filing the corporate tax return: 1) balance sheet in English; 2) income statement in English; 3) statement of appropriation of retained earnings or disposition of deficit in English; 4) statement of changes in financial position in English; 5) corporate tax returns filed with foreign governments; 6) schedule of selling and general administrative expenses in English; 8) schedule of the notes to the financial statements in English.

D. Mandatory submission

The Korean tax authorities can request the obligatory submission of data or supporting documents related to international transfer pricing. In this connection, the new transfer pricing rules specifically enumerate the following information and documents relating to the overseas transactions in question to be kept and submitted upon request to the Korean tax authorities by the domestic corporation in question. Document Analysis: 1) transfer deed or purchase agreement of the assets; 2) product price list; 3) breakdown of product manufacturing costs; 4) details of transactions conducted with unrelated parties for major products; and 5) in cases where services have been provided or other transactions not involving inventories, the information and supporting documents equivalent to those just enumerated. Tax Audit or Investigation: 1) information and supporting documents as listed above; 2) corporation's organization chart and job descriptions; 3) data used for determination of international transaction price; 4) policy for price determination within the group of companies; 5) guidelines for accounting treatments; 6) description of the functions performed by each party relating to the overseas transaction; 7) practices performed/established by other parties engaging in the overseas related companies; 8) other information and supporting documents necessary in computing the arm's length price.

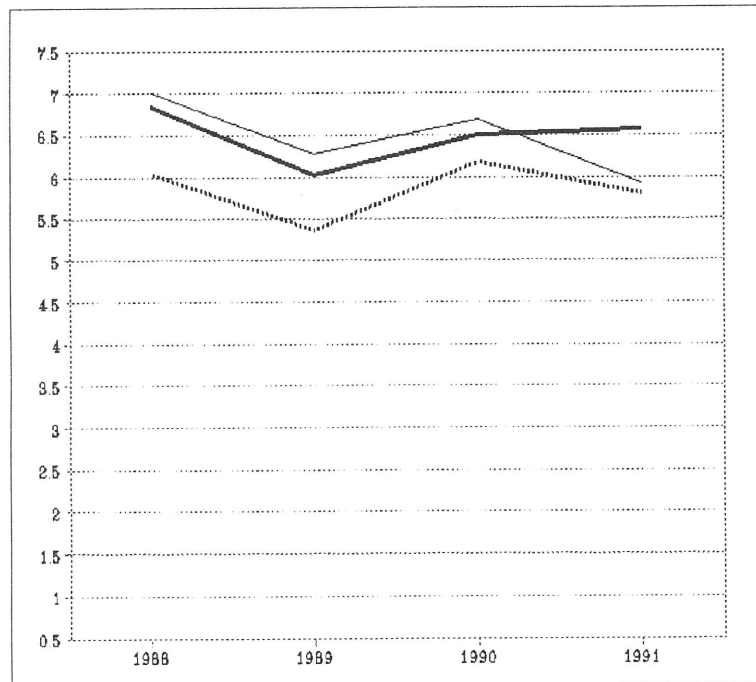
Appendix 3. Profit rate of foreign invested firms

Figure 1.a Profit/Sales of Manufacturing Sector
(R > 70%)



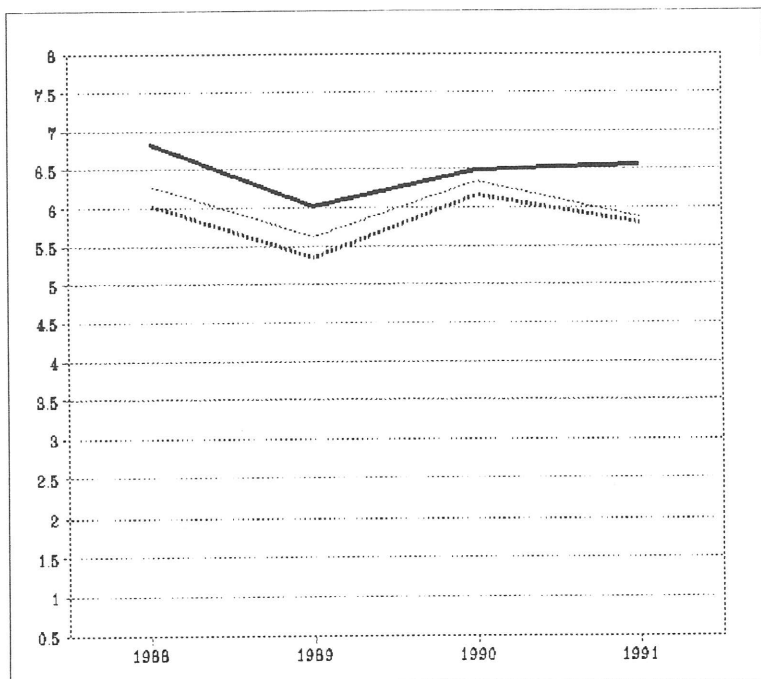
— All firms in Korea
 Foreign invested firms
 - - - Foreign invested firms with R > 70%
 R = Foreign investors' share

Figure 1.b Profit/Sales of Manufacturing Sector
(40% < R ≤ 70%)



— All firms in Korea
 Foreign invested firms
 - - - Foreign invested firms with 40% < R ≤ 70%
 R = Foreign investors' share

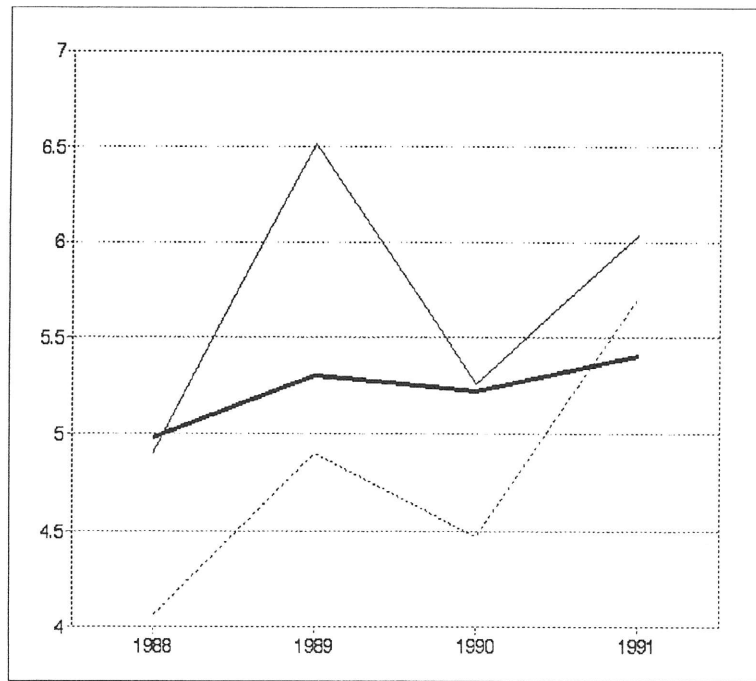
Figure 1.c Profit/Sales of Manufacturing Sector
($R \leq 40\%$)



— All firms in Korea
..... Foreign invested firms
- - - Foreign invested firms with $R \leq 40\%$
R = Foreign investors' share

Figure 2.a Profit/Sales of Foreign Invested Firms
with R > 70%

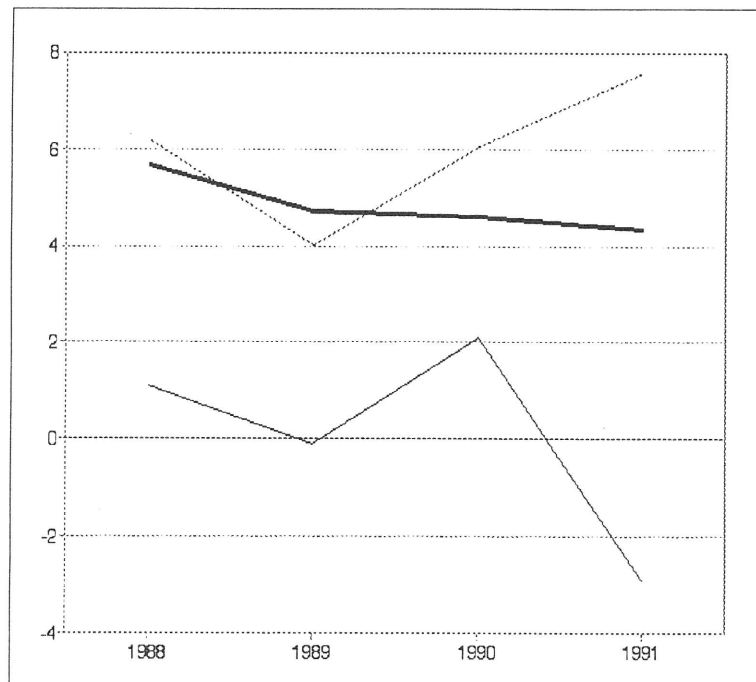
(Food & beverages)



— All firms in Korea
 Foreign invested firms
 — Foreign invested firms with R > 70%
 R = Foreign investors' share

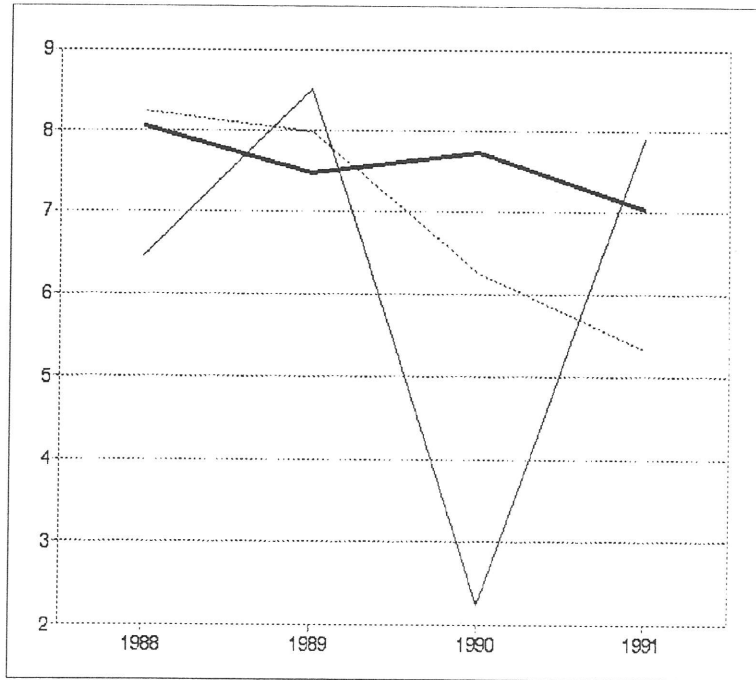
Figure 2.b Profit/Sales of Foreign Invested Firms
with R > 70%

(Textiles, wearing apparels & leather)



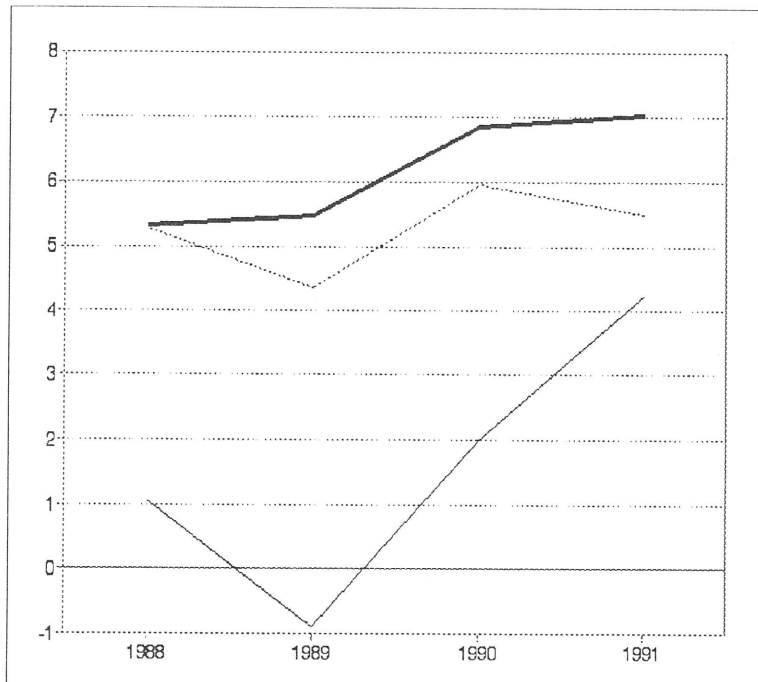
— All firms in Korea
 Foreign invested firms
 — Foreign invested firms with R > 70%
 R = Foreign investors' share

Figure 2.c Profit/Sales of Foreign Invested Firms
with R > 70%
(Chemicals, petroleum, coal, rubber & plastics)



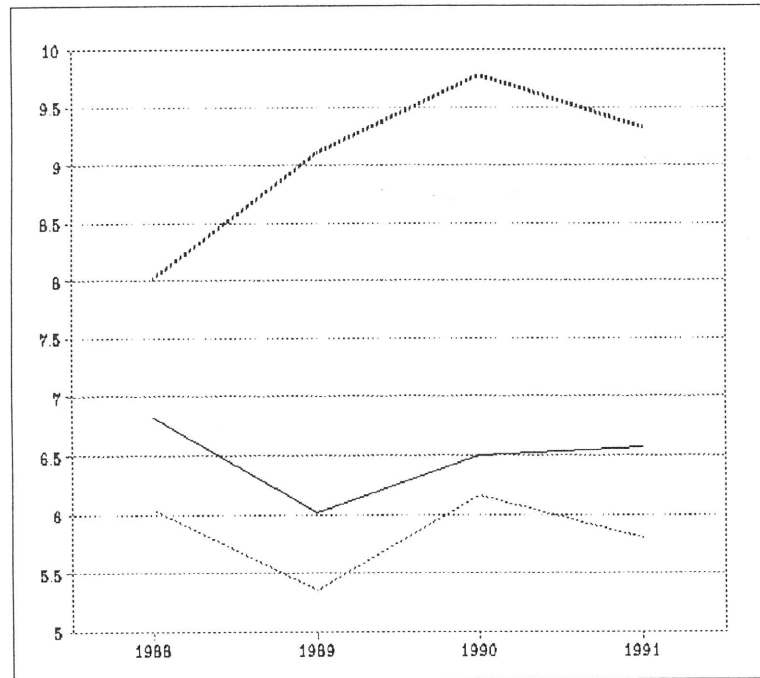
— All firms in Korea
 Foreign invested firms
 — Foreign invested firms with R > 70%
 R = Foreign investors' share

Figure 2.d Profit/Sales of Foreign Invested Firms
with R > 70%
(Machinery)



— All firms in Korea
 Foreign invested firms
 — Foreign invested firms with R > 70%
 R = Foreign investors' share

Figure 3.a Profit/Sales of Foreign Invested Firms
with $R \geq 50\%$
(From the Credit by Source Country)



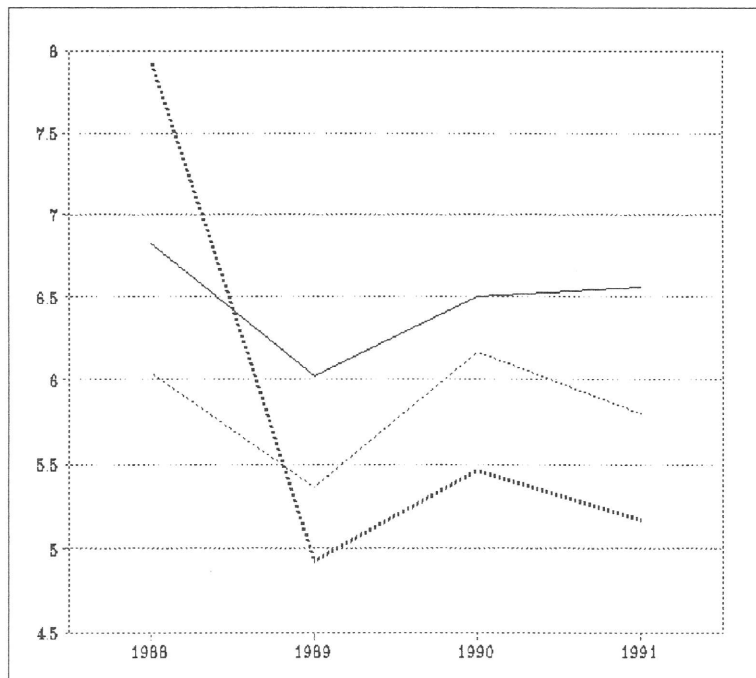
----- Foreign invested firms with $R \geq 50\%$
 — All firms in Korea
 - · - Foreign invested firms
 R = Foreign investors' share

Figure 3.b Profit/Sales of Foreign Invested Firms
with $R \geq 50\%$
(From the Worldwide Credit Countries)



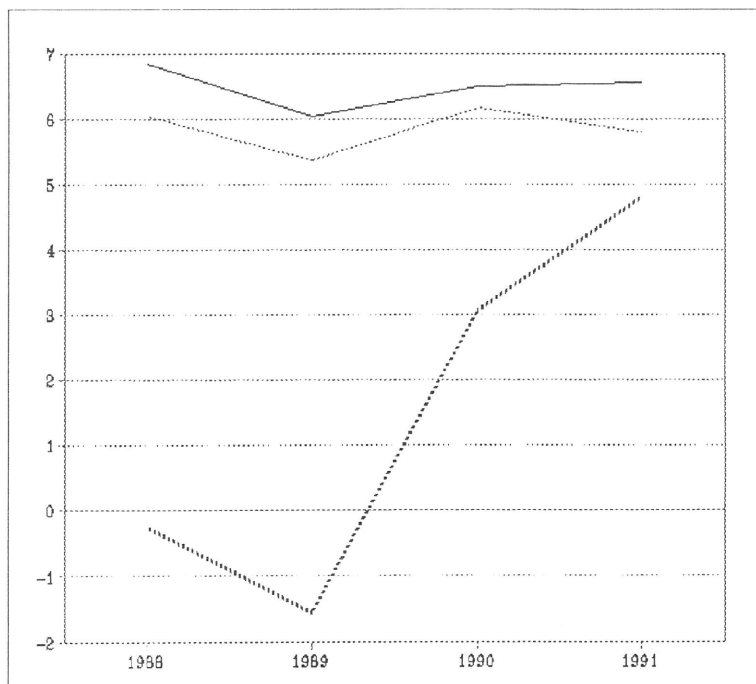
----- Foreign invested firms with $R \geq 50\%$
 — All firms in Korea
 - · - Foreign invested firms
 R = Foreign investors' share

Figure 3.c Profit/Sales of Foreign Invested Firms
with $R \geq 50\%$
(From the Tax Exemption Countries)



..... Foreign invested firms with $R \geq 50\%$
 — All firms in Korea
 - · - Foreign invested firms
 - - - R = Foreign investors' share

Figure 3.d Profit/Sales of Foreign Invested Firms
with $R \geq 50\%$
(From the Low Tax Countries)



..... Foreign invested firms with $R \geq 50\%$
 — All firms in Korea
 - · - Foreign invested firms
 - - - R = Foreign investors' share

