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An Old Tale with Some New Perspectives: On Taxation of Royalty Income Relating to US-Registered Patents under the Korea-US Tax Treaty

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The article focuses on a long-standing conflict between the Korean tax authorities and the courts in respect of "royalties" as prescribed by the tax treaty between the Republic of Korea and the United States. In this specific but significant set of circumstances, a Korean resident manufactures certain goods with a view to selling them in the US market, and in the course of its manufacturing, infringes upon a US Patent. Disputes have arisen as to the source and nature of the arising cross-border payments.

1. Introduction

1.1. Fact pattern

The focus of this article is on a simple, but specific fact pattern, in which a company resident in the Republic of Korea (Korea) manufactures certain goods with a view to selling them in the US market. For this purpose, this Korean manufacturing company (K Manufacturer) sets up a US subsidiary, which in turn operates as a distributor (US Distributor). The relevant legal issue has to do with the fact that the K Manufacturer, in its course of manufacturing, takes advantage of an invention that is protected by a patent registered in the United States (US Patent). The K Manufacturer either obtains a licence from the holder of this US Patent for royalty payments, or operates its production without a licence, that is, commits an infringement on this US Patent to become liable for the damages. In terms of income tax, the usual consensus is that any indemnification payment for the said damage should be characterized as a payment of royalty,[1]an understanding which is generally, albeit implicitly, shared by the Korean courts. In the same vein, this article does not distinguish the two scenarios.

1.2. Legal Issue

As will be further reviewed in this article, the Korean tax authorities have long held on to the position that the relevant royalty income derived by the US Patent holder has its source in Korea, and thus is subject to Korean withholding tax. The applicable statutory withholding tax rate under the Korean Corporate Income Tax Act (CITA) is 20%,[2]which should, however, be reduced to 15% under the tax treaty concluded between Korea and the United States.[3]It is worthwhile to mention that this Treaty was signed some 45 years ago,[4]which makes it one of the oldest Korean tax treaties yet in force. A simple, yet fiercely debated legal issue under this Treaty is whether the relevant royalty payment (Payment) indeed results in Korea-sourced royalty income, which then would be subject to the said Korean withholding tax.

Regards should be had to the specific provisions of the Treaty, which determine the source of different types of income that are separately and distinctly dealt with in the Treaty. When it comes to the category of royalty income, article 6 (3) of the Treaty provides as follows:

> Royalties described in paragraph (4) of Article 14 (Royalties) for the use of, or the right to use, property (other than as provided in paragraph (5) with respect to ships or aircraft) described in such paragraph shall be treated as income

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Some of the ideas contained in this article, particularly those in sec. 6.3., were presented in the author's recent article, *Neue Wege or New Ways to Explore – How to Tax Royalties or Damages Arising from Use of U.S.-registered Patents under the Korea – U.S. Tax Treaty* , published in Korean in the Journal of IFA Korea Vol. 36 No. 4 (2020).

1. *OECD Model Convention on Income and on Capital: Commentary on Article 12* para. 8 (21 Nov. 2017), Treaties & Models IBFD [hereinafter referred to as *OECD Model*].
2. Art. 98, para. 1, item 6 CITA.
3. *Convention between the United States of America and the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and the Encouragement of International Trade and Investment* art. 14, para. 1 (4 June 1976), Treaties & Models IBFD [hereinafter referred to as the Treaty].
4. The Treaty was signed on 4 June 1976 and came into effect on 20 Oct. 1979.

from sources within one of the Contracting States *only if paid for the use of, or the right to use, such property within that Contracting State* . [Emphasis added.]

According to this provision, “royalties ... for the use of, or the right to use” patents[5]should be considered as sourced in one of the contracting states within which the patents are “used” or to be “used”. Against this backdrop, the issue narrows down to whether the US Patent is “used or to be used” within Korea or the United States under the fact pattern in question.

2. “Old” Case Law

2.1. Leading case (1992)

The leading case,[6]so to speak, dates back to 1992, where the Supreme Court of Korea (Court) held that the royalty income received by a US-based oil company from Hyundai Motor Co., a K Manufacturer, is not sourced in Korea. In this case, the aforesaid US company owned a US Patent not registered in Korea, and Hyundai Motor made certain use of the material protected by this US Patent in the course of producing cars, which were subsequently sold in the US markets through Hyundai Motor America Co., a subsidiary of the said K Manufacturer, that is, a US Distributor.

The Korean tax authorities argued that the US Patent was “used” within Korea, thus the relating Payment results in a Korea-sourced income. However, the Court had a different idea and held as follows:

> [...] the royalty in question was paid by the [plaintiff]’s U.S. subsidiary as a consideration for the infringement or use of the patent rights that [the U.S. company] has in the U.S., which was effectuated when the cars produced by the [plaintiff] were imported into, and sold in, the U.S. It was obviously not paid as a consideration for use in Korea of the patented material. Therefore the royalty, as it may qualify as U.S.-sourced income, cannot be viewed as sourced in Korea.[7]

It should be further noted that this decision expressly draws upon the concept of “territoriality” in patent law. According to the Court, the patent has its legal effects only in the jurisdiction where it is registered. The Court is of the view that, if a patent can ever be “used”, it is theoretically conceivable only in that jurisdiction where the patent is registered. Because the place within which the patent is “used” is determinative under the Treaty, the Court concluded, in this fact pattern, the royalty income of the US Patent holder is not sourced in Korea (but rather in the United States).

2.2. A new decision re-confirming the old case law (2007)

The Korean tax authorities had no intention whatsoever to yield to this view of the Court’s, which they instead largely ignored. However, they could no longer keep their eyes closed to this case law when the Court reaffirmed its position in yet another decision in 2007.[8]The Court in this case, again, clearly stated that, under the Treaty, royalty income sourced in Korea can arise only if a US company receives royalty payment for a patent registered in Korea. The Court again refers to the principle of territoriality in this connection and cited none other than the foregoing 1992 leading case.

3. Tax Administration “Strikes Back” (2008)

After the second decision of the Court in 2007, which the Korean tax administration must have regarded as simply unacceptable, they considered various ways to reverse the situation and secure their tax revenue from the Payments. Along with the usual *inside-the-courtroom* efforts to persuade the Court into reconsidering their case law, they attempted to amend the CITA at the end of 2008 so it provides explicitly that such royalty income is sourced in Korea. The part of the law enacted shortly afterwards read as follows:[9]

> In such cases, as for rights that need registration to exercise the rights, such as patent rights, [...] the relevant patent rights, etc. shall be *deemed to have been used in the Republic of Korea, irrespective of whether they were registered in the Republic of Korea* , in cases where the relevant patent rights, etc. were registered out of the Republic of Korea and have been used for manufacture, sale, etc. in the Republic of Korea[.] (Emphasis added.]

As it can be easily inferred from above, they thought that the Court was wrong in not finding the source of the said royalty income to be in Korea and therefore tried to make the Court statutorily bound to see it as Korea-sourced.

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5. Needless to say, “patent” belongs to the group of “property” as referred to in art. 14(4) of the Treaty along with copyrights, trademarks, designs, models, secret processes and so on.
6. This is a decision rendered by the Supreme Court of Korea on 12 May 1992 with a case identification code of 91 *nu* 6887.
7. There seems to be no publicly available translation of the decision so the quoted text is translated by the author.
8. Decision by the Court issued on 7 Sept. 2007 with a case identification code of 2005 *du* 8641. The plaintiff of the case was Daewoo Electronics Co.
9. This is art. 93, item 9 CITA, which was in force until the amendment of the CITA at the end of 2019. This end-2019 amendment will be discussed later in sec. 5.1. The translation of the quoted text comes from www.law.go.kr operated by the Ministry of Legislation of Korea (accessed 18 May 2021).

4. Return of the “New” Case Law (2014)

As time went by, other cases of a similar fact pattern ensued, to which the newly amended law was seemingly applicable. Some taxpayers nevertheless went on to rely on the “old” case law and challenged the new law. The opinion of the Court on this renewed appeal by taxpayers was first expressed in late 2014, which must have taken the tax authorities somewhat by surprise, who certainly believed that the issue was no longer alive.

This 2014 decision[10] first reiterated what was held in the two earlier cases. It additionally went on to explain that the reason for its reliance on the previous case law in spite of the 2008 amendment of the CITA was not based on domestic law, but the relevant part of the Treaty itself. This position is best summarized in the following part of the decision:[11]

> *Under the statutory construction of the Korea-U.S. Tax Treaty* , it is impossible for patent rights to be infringed, hence inconceivable to either use the patent rights or pay royalties for their usage[,] outside of the country in which they are registered. [Emphasis added.]

The Court here unequivocally states that their conclusion hinges on the Treaty itself and is a logical consequence of its interpretation thereof. Logically, what is said in a treaty cannot be superseded by a domestic law provision unless one is ready to get tangled in a difficult terrain of treaty override. This is tantamount to reducing the above-mentioned 2007 amendment to the CITA as envisaging something that is simply “inconceivable”. This “new” case law was subsequently reiterated in another decision in late 2014,[12] and yet again in 2018.[13] Hence it seems fair to say that it stands as the only authoritative interpretation of the Treaty in Korea to this date.

An issue connected with a peculiar provision in Korean tax law

There are a couple of intriguing issues that deserve, at this stage, to be touched upon. The first one relates to the now-deleted article 28 of the Korean Adjustment of International Taxes Act, which provided as follows:[14]

> Article 28 (Preferential Application of Income Classification under Tax Treaty)
>
> The provisions of the tax treaty shall preferentially apply to the classification of a domestic source income of a nonresident or foreign corporation, notwithstanding [...] Article 93 of the [CITA].

Article 28 basically stated that, as far as “classification of a domestic source income” is concerned, treaty law enjoys superiority to domestic tax law, although the exact context of the above-quoted term was anything but clear. This somewhat peculiar article gains relevance in that the Court, in its decisions, refers to this article (albeit very briefly) to support its position, which implies that the “classification” of the Payment as US-sourced royalty income under the Treaty should be respected even when it comes to applying the newly amended provisions of the CITA. The Court effectively held that any domestic law provision that changes or affects “classification of income” under a tax treaty is invalid because of the above article 28 (and not because it is an unauthorized treaty override).

Since this problematic provision was repealed at the end of 2018, the question arose as to whether one should now *a contrario* reach the opposite outcome, i.e. full application of the CITA is not hindered by the Treaty. To have a better grasp of this peculiar issue, let us take an example. It goes without saying that, if a tax treaty classifies an item of income as royalty, this income should be considered as royalty as far as the application of this tax treaty goes. If this mere tautology is what article 28 means, then this article has simply no meaning. This much is, of course, more than clear. What is controversial is whether, under this article, the income should also be treated as royalty income at the dimension of domestic law application even though the domestic law of itself provides that this is, for instance, business income. As the Court has refrained from further revealing how it understood the foregoing article, it is thus also not clear as to what the exact role of this article in the Court’s reasoning was.

Issue of “other income”

Relying on the said article 28 or not, the Court is firmly of the opinion that the Payment is US-sourced royalty income under the Treaty. The Treaty limits Korean withholding tax on royalty income sourced in Korea that is paid to a US resident to a certain

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10. A decision rendered on 27 Nov. 2014 with a case identification code of 2012 *du* 18356. The relevant K Manufacturer in this case is Samsung Electronics Co., but the plaintiff in this case the US recipient of the royalty income, Semiconductor Components Industries LLC.
11. The Court has publicly provided its own full-text translation of the decision on its website https://library.scourt.go.kr/SCLIB_data/decision/2012Du18356.htm , from which the quoted text comes (accessed 18 May 2021).
12. Decision of 11 Dec. 2014 with the case identification code of 2013 du 9670, of which the relevant K Manufacturer is also Samsung Electronics, and plaintiff of the case is a certain e.Digital Corporation.
13. Decision of 27 Dec. 2018 with the case identification code of 2016 du 42883, of which the relevant withholding agent, K Manufacturer and plaintiff of the case is also Samsung Electronics. The ultimate recipient of the royalty income is Intellectual Ventures Global Licensing LLC.
14. The translation comes from www.law.go.kr operated by the Ministry of Legislation of Korea (accessed 18 May 2021).

level specified therein, but typically says nothing of US-source royalty income. The issue that follows is, again, whether the Korean tax authorities then should be allowed to tax this income entirely under their domestic tax law without being prohibited by the Treaty, which happens to have no provision in respect of "other income".

The fact pattern can be summarized as a case where an item of income that is characterized as US-source royalty income under the Treaty and derived by a US resident is taxed under Korean domestic law. There may be two possible approaches for this problematic situation. On the one hand, it could be argued that, because the Treaty only limits Korean taxation on royalty income sourced in Korea and derived by a US resident, the Treaty should impose no restriction whatsoever on taxation of US-sourced royalty income derived by a US resident. This is also equivalent to treating it as belonging to the category of "other income".

One may disagree with this outcome on the other hand, asserting that it runs counter to the basic allocation of taxing power on royalty income under the Treaty. In other words, it may sound absurd that, Korea is authorized to exercise its full taxing power on royalty income that is sourced in the United States (which means it is connected rather with the United States than with Korea), but such power is limited in case of royalty income sourced in Korea (which has a much closer tie with Korea). The latter understanding may constitute the inherent backbone of the current case law of the Court, which has nevertheless never been clearly articulated in its case law.

5. Tax Administration "Strikes Back (Season 2)"

5.1. Introduction of a new CITA provision

The Korean tax authorities have constantly shown surprising endurance and tenacity with the issue. Indeed, they went as far as succeeding in the enactment of another new law at the end of 2019, which basically states that a payment in a consideration for the " *de facto* use in Korea of production method, technology or information" protected under a US Patent should result in royalty income sourced in Korea. Applied to the very fact pattern discussed throughout this article, however, it is doubtful that this new provision will bring the tax administration the result it must have aimed at. This law draws a dividing line between the "use" of a patent itself, and that of "method, technology, etc." protected by a patent. In the first place, however, whether they are concepts that can be distinguished from each other is highly questionable. Even if they are, since the Court has consistently found that there was indeed use of a US Patent, it is unlikely that the Court will now change its perception to find that, under these circumstances, there is in fact use of "method, technology, etc.", for which the K Manufacturer made royalty payments.

5.2. Another CITA provision with respect to "other income"

The new CITA provision discussed in the preceding subsection is not the only attempt made in 2019 by the legislature and tax administration. When it comes to the issue of patent infringement (and excluding licensed uses thereof), the "infringer" often is held liable to indemnify for the damages that he has caused to the patent holder. As a matter of principle, the indemnification may consist of a number of different and distinct components. As for the portion that corresponds to the royalty in its pure sense, the ordinary agreement is that it should be treated as royalty income unlike its qualification from general law perspectives.[15]

In a desperate attempt to overcome the firmly established case law, however, the Korean legislature and tax administration in a joint effort, amended the CITA so that it now provides that any indemnification payment made in Korea for an infringement of a US Patent is not royalty income, but "other income". Whether this new provision is capable of making any positive contribution to the Korean *fisc* is, again, doubtful.

Where the "pure royalty" portion is concerned, this domestic law provision clearly clashes with the general consensus that this payment of indemnification qualifies as royalty income, not to mention that the Court has always found royalty income to exist in this fact pattern and the Court is of the view that this is the correct outcome under the Treaty. Thus, it is unlikely for the Court to revisit and reconsider its case law simply because there has been a change in domestic law. One caveat in this regard, however, is that the other components of the indemnification payment may be handled in a different manner, which will be discussed later in this article.

6. Remaining Issues

6.1. Background

The long-debated issue in this fact pattern is, of course, the source of income derived from the Payment made in connection with a US Patent. Because this Payment qualifies as royalty income, the issue would normally be solved these days by

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15. *Supra* n. 1 .

reference to the residence of the payor.[16] However, the difficulty unique to this fact pattern lies in the fact that the Treaty, which is now more than 40 years old, sticks to the so-called "place of use" rule. In fact, among the more than 80 tax treaties Korea has in force, this Treaty is the only one that still maintains this somewhat outdated rule. This means that no matter what the CITA may provide with respect to the source of royalty income, the only potentially affected tax treaty is the one concluded with the United States.

Since the "place of use" rule is not widely in use nowadays, there is a relatively small amount of academic literature available outside of Korea. The Commentaries on Articles 12 of both the OECD and UN Model tax treaties do not shed much light either. The OECD Model, which does not at all permit the source state to levy tax on royalty income has no reason to discuss its source in the Commentary, and indeed it does not. The UN Model on the other hand refers to the source rule, but its primary focus is on the residence of the payor rather than the "place of use".[17]

Suffering from a lack of clear guidance available from the two most prominent international organizations in this area, Korean commentators tend to find some support for the current case law in the United States[18] as well as a decision rendered by the Japanese court.[19] Yet, even these foreign cases in favour of the Korean case law, have not silenced the opposing view. Indeed, any discussion of source of income at an abstract level is more or less likely to share such a fate because of the essentially elusive nature of the concept. With commentators divided, and a lack of global standard or foreign literature that may be comfortably relied on, one certainty is that, once the Court has established its stance, it is unlikely to be changed in the near future. Any discussion connected with this case law or the fact pattern in question should be understood against this background.

6.2. Issues that have already been identified by commentators

There are a couple of issues that commentators in Korea have identified while reviewing the rationale of the Court's case law but which have not received due attention anywhere in the Court's decisions. The lack of proper discussion on these issues indeed constitutes an undeniable weakness of the Court's reasoning, and the author believes it worthwhile to briefly articulate them at this stage, although it seems still unrealistic to believe that these defects will lead the Court into reconsidering its case law.

6.2.1. The general *renvoi* clause

The concept of "use of patent" is crucial in determining the source of royalty income that is at issue in this article. At this juncture, one may note that this term is not defined under the Treaty, which contains a provision that is similar to article 3, paragraph 2 of the OECD Model. According to this provision, which is sometimes labeled as a general *renvoi* clause, any undefined treaty term should be construed with reference to domestic law of the relevant contracting state, "unless the context otherwise requires".

In its case law, the Court gives a clear meaning to the term "use of patent", interpreting it as it sees fit. However, the Court has never made any attempt to justify its understanding of the term in the framework of the said general *renvoi* clause. If the Court generally adheres to the so-called "ambulatory approach", in that it interprets any term not defined under a tax treaty consistently with the domestic law as it evolves in the course of time, then the only possible explanation for a divergence is that the Court is of the view that "use of patent" is an autonomous term of the Treaty, disconnected from the meaning under domestic law. This is also equivalent to saying that the Court has found some "context" that requires "use of patent" to be interpreted as established by case law, and not as per current domestic statutory law.

Admitting that the concept of "context" itself is ambivalent to a certain extent, it needs to be further pointed out that the Court has never clarified or even come close to mentioning as to what context it has relied upon in reaching its decision.

6.2.2. Treaty override(?)

The Court regards its opinion as the right interpretation of the Treaty, and in effect holds that this outcome is dictated by the Treaty itself. On the other hand, the Congress has clearly manifested its intention to deprive, directly or indirectly, this conclusion of any effect. In a sense, this is a situation where provisions of a tax treaty and domestic law contradict each other, from which one can easily recall the controversial concept of treaty override. However, this situation differs from the classic case thereof, where there is no disagreement on what the relevant treaty provision means.

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16. Art. 12(5) of the UN Model tax treaty provides that royalty income arises in the country where the payor is resident.
17. *United Nations Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 12* para. 19 (1 Jan. 2017), Treaties & Models IBFD.
18. The frequently cited case is *AMP Inc. v. United States* , 492 F.Supp. 27 (1979).
19. This decision is sometimes referred to as *Silver Seiko* according to the name of the plaintiff-taxpayer of the case. It is a decision issued by the Supreme Court of Japan on 25 Sept. 2004.

In any case, since the legislative intent behind the newly amended provisions of the CITA is evident, it could be argued that such a congressional intent should eventually prevail over treaty law. This is because under the Korean legal system, statutes enacted by the Congress and treaties ratified by the same institution have equal value,[20]meaning that the priority of *lex specialis* or *lex nova* should be the controlling norm. In other words, the new law with some manifest congressional intent should supersede provisions of the Treaty. Although this seems to be a logical outcome and is indeed supported by a few Korean commentators, a certain general reluctance is also shared among other Korean experts, that is, both commentators and officials, who believe that a treaty override, being an unlawful act of state, should not be accorded any legal effect whatsoever.

Regardless of one's opinion on this unsettled issue, it could be plausibly argued that, in order to disregard altogether the authority of the newly amended law, the Court should have considered whether this is a case of treaty override, and accordingly, whether this new law that contradicts the Court's interpretation of the Treaty, can still stand as a valid *lex specialis* or *lex nova* . This seemingly indispensable step was, however, entirely missing in their decisions.

6.3. Further issues that have not yet been touched upon

6.3.1. Transfer pricing perspectives

Source rule is not the only legal standard that is relevant in allocating tax revenues among jurisdictions. Generally, transfer pricing (TP) in this respect is, if not more, important especially given the specific fact pattern that is the subject matter of this article. The relevance of the TP rule has to do with the fact that in all of the court cases referred to above, the K Manufacturer solely made the entire Payment. If one accepts the preposition that the US Patent can at a "conceptual" level only be used or infringed in the US territory, the question arises as to whether the K Manufacturer was involved in the act of "use of patent" at all. This enquiry seems to warrant fact-specific answers, which can differ from one another depending on the case in consideration. However, irrespective of whether the K Manufacturer can be regarded as being actually engaged in the act of "use of patent", there is no denying that the US Distributor at the very least took part in such acts, if not the sole responsible entity. Accordingly, the US Distributor, at least from a theoretical perspective, is always liable to make the Payment, either wholly or in part. Viewed from a business perspective and taking into account the real-world relationship between the two companies, that the K Manufacturer made the whole payments may be somewhat understandable commercially, but it is much harder to justify in terms of TP rules. After all, this Payment would likely be deducted from the Korean income tax base and would consequently result in less tax revenue for the Korean *fisc* , which is exactly the kind of concern that lies at the heart of the whole TP regime. Therefore, due attention is required as to how much of such a Payment should be deductible from the Korean income tax base. Although this specific issue is not one that is frequently discussed, this discussion clearly belongs to the realm of TP rules.

Needless to further elaborate, the core of these rules is that any transaction between related parties should be priced according to the so-called arm's length standard. This standard leads to a search for the terms of a transaction that would have been agreed upon if the same or a sufficiently similar transaction had hypothetically occurred between unrelated parties. Accordingly, if one can find an actual case where a foreign manufacturer and its unrelated US distributor share an obligation to pay royalty to a US Patent holder, the terms of transaction that are applied in this case should also serve as a point of reference. This real-world case must be, of course, sufficiently similar to the point that this case qualifies as "comparable", so to speak. It is however often admitted that cases that are comparable enough are hard to find, particularly when it comes to cases where use of intangible assets is concerned.

At this juncture, it needs to be pointed out that the risk of patent infringement may sometimes be contractually borne by the K Manufacturer although it may not, technically speaking, engage in the act of infringement. If this is indeed the case, the issue becomes whether this function assumed by the K Manufacturer is duly rewarded by the US Distributor, possibly resulting in a larger income for the former. The size and appropriateness of the said reward itself is, of course, subject to TP analysis. In the same vein, the K Manufacturer may assume *ex ante* the liability to pay the relevant royalty to the US Patent holder, which should be wholly or partly reimbursed by the US Distributor, the sub-licensor, who is in any case more deeply (if not solely) involved in the use of the US Patent.

How to allocate or "split" the payment between the related parties

If that is not the case, that is, no prior determination exists as to the absorption of the foregoing risk, then the resulting liability for the Payment should be allocated between the two companies in proper accordance with TP rules. Assuming that there is no comparable transaction that can be relied upon, the so-called profit split method is the usual means of last resort. Only,

20. Art. 6(1) of the Constitution of Korea states that international treaties have "the same effect as the domestic laws" of Korea. The translation comes from www.law.go.kr operated by the Ministry of Legislation of Korea (accessed 18 May 2021).

in this respect, it is a split of “expense” that is at issue rather than a “profit” split.[21] In any case, the basic premise is that the expense of the Payment should be allocated between the K Manufacturer and the US Distributor based on the arm’s length principle. There is no straightforward way to know how to make such an allocation, regardless of whether it is profit or expense split. Profit split according to each related party’s contribution or so-called residual profit split has been the subject of intense discussion, but how to determine the ratio of such relative contributions or how to divide the residual profit is still an area of ongoing debates rather than established consensus.

This uncertainty and lack of authority may leave room for a rather creative way to conduct such a division. The method which this article suggests consists of borrowing the approach adopted in the field of cost contribution arrangement, which is a special part of the broader TP regime, usually connected with intangibles. Although the arm’s length principle is still the prevalent norm, the basic assumption in this area is that, if the related parties share the relevant cost in proportion to each party’s “anticipated benefits”, the arm’s length principle is duly observed.[22] Since the aggregate conglomerate, to which both the K Manufacturer and the US Distributor belong, may choose between obtaining a licence from the US Patent holder or developing some substitute at its own expense, it is argued here that the expense of the Payment should be allocated in the same manner as the hypothetical development costs, that is, in accordance with each party’s benefits anticipated (or actually accrued) from the licence or infringement of the US Patent. One may aptly add that this outcome is also justified by the concept of tax neutrality (i.e. treating the licence fee or infringement damages and development costs alike).

Details of the proposed method

As a starting point, it is necessary to carve out the total benefit that is attributable to the use or infringement of the US Patent. Note should be taken in that, in case of an infringement, it is the already accrued (rather than anticipated) benefit that should count because the amount of royalty payment in this scenario is determined *ex post* . In any case, this total benefit should then be divided between the K Manufacturer and the US Distributor, and the consequent ratio calculated.

What is conceptually interesting in this respect is that this ratio cannot be determined merely at the factual dimension. In this fact pattern, the businesses of the two companies are, so to speak, vertically integrated, and their respective income or profit is of itself subject to the TP rule. In other words, the term of the intra-group transaction between the two companies should first be fixed by use of some kind of TP methods (resale price method or profit split method, for instance), and the ratio of the relevant anticipated or accrued benefits should be computed accordingly.

After all, this two-step process may as a whole be also labeled as a sort of “expense split”, which is the flip side of “profit split”. The peculiarity lies in that the method of “split” is inspired by the arm’s length principle as applied in connection with the cost contribution arrangement.

It may be, as always, a tricky business to reach the correct outcome from TP viewpoints, but once one attains the outcome of a correct application of the arm’s length principle, its consequence is that the amount in excess of the right portion determined according to the arm’s length principle should not be deductible, and such disallowed deduction is transformed into Korean tax revenue. Although the focus of this article is not how to compensate for the loss of Korean tax revenue potentially caused by the Court’s case law, this possibility may give some relief to the Korean tax authorities in this fact pattern and save them time and energy which they would otherwise keep spending away endlessly in order to reverse the Court’s case law. The downside of this approach is, of course, that any TP analysis is doomed to be much more time-, and resource-consuming than simply relying on favourable source rules.

6.3.2. Treatment of punitive damages

As already seen in section 5.2. , the legislature influenced by the tax administration inserted at the end of 2019 a new statutory provision that characterizes certain indemnification payments as “other income”. It was noted above that this provision is largely ineffective to the extent that the indemnification covers the portion of royalty lost due to the infringement committed by the US Distributor and K Manufacturer, for which the reason was elaborated in the aforementioned section.

However, the Payment may also contain a portion that reflects the so-called punitive damage under the US patent law which generally is said to result in “other income” under tax treaties.[23] It is also relevant in this regard that the Technical Explanations to the US Model Tax Treaty has consistently maintained the same position.[24] This leads to the conclusion that payment resulting from award of punitive damages cannot qualify as royalty income. To this extent, therefore, the new law can operate

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21. The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* , at para. 2.114, Primary Sources IBFD [hereinafter referred to as *OECD Guidelines*], also refers to “split” of “losses,” although whether this mention goes as far as meaning “split” of a specific expense is arguable.
22. *OECD Guidelines* , at para. 8.5.
23. E. Reimer & A. Rust eds., *Klaus Vogel on Double Taxation Conventions* (4th ed., Kluwer Law International 2015), p. 1543.
24. *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006* , p. 62, Treaties & Models IBFD.

as intended by the legislature. In other words, the punitive damage portion included in an indemnification payment should not be characterized as royalty income or any other income separately dealt with in the Treaty. The result that follows would be full Korean taxation in accordance with its domestic CITA.

Although this outcome seems, at first glance, impeccable, there is one caveat. Most patent disputes end via settlement, in which case it is hard to carve out the portion that strictly represents punitive damages from the rest. Domestic law may consequently be required to introduce certain measures that help the tax authorities identify such a portion that corresponds to punitive damages. In this respect, a parallel may be drawn with another CIT provision. The CITA disallows deduction of a payment made to a third party as punitive damages "according to foreign law", and when the size of such a payment is not clear, it presumes that two thirds of the total payment make up punitive damages.[25]Admitting that the soundness of this presumption is debatable by all means, similar measures can be taken into consideration for the issue of "other income".

7. Summary and Concluding Remarks

The author has in this article, in a largely descriptive and informative, and only very occasionally analytical manner, dealt with the long-debated issue of Korean income taxation of royalty payments made by Korean manufacturing companies in connection with patents registered in the United States (and not in Korea). Since the Supreme Court of Korea rendered its first decision on the issue in 1992, many incidents have followed one another, in particular during the last 15 years. Indeed, dynamic interactions among the legislature, the administration and the judiciary have taken place thus far.

After all, one observes that the judiciary has remained faithful to its first case law, of which the potential or actual adverse revenue effect has continued to be a source of grave concern for the legislature and the administration. The two branches in many joint efforts amended the relevant provisions of corporate income tax law in order to secure Korean taxation on the said royalty payment. In the first place, they changed the law in 2007 so that it explicitly provided for the said royalty income to be sourced in Korea. When it became clear that this amendment could not persuade the Court into reconsidering its case law, the law was amended again so that the use of inventions (i.e. "method, technology, etc.") protected by US Patents in Korea, rather than the use of the actual patents themselves, may lead to finding of Korea-sourced royalty income, which nonetheless seems to the author, likely to share the same fate as the first amendment.

At the heart of all this commotion lies the fact that the Court finds the root of its case law in the application of the Treaty rather than that of Korean domestic law. The Court seems to believe that no change in domestic law can affect the basic revenue allocation of royalty income that was agreed between the two contracting states. The conceptually easier way-out for the Korean tax authorities from this deadlock would be a future amendment of the now-more-than-40-years-old Treaty, but at present there is no imminent prospective for such a renewal of the Treaty between the two countries. The Korean tax authorities may also well attempt to reach a mutual agreement[26]with the US tax authorities, but they have never sought this apparently straightforward way out either.

That being said, this article pointed out two issues that have largely been ignored by the Korean tax authorities, which are transfer pricing and income characterization of punitive damages. Although each of the two ways out has limits and practical difficulties, they may be options worth considering, particularly from the perspectives of the Korean tax authorities.

It is not uncommon that the Korean tax authorities attempt to de facto reverse unfavourable court rulings by way of amending the relevant part of tax law, which the legislature has usually not considered as a particularly problematic practice. The issue covered in this article is unique in that this common practice did not work because the relevant part of law came from a treaty. Not interested in pursuing treaty-based solutions such as renegotiation or mutual agreement, at least in a short run, the Korean tax authorities now seem to be lost as to what to do. In this respect, this long story of the Korean tax authorities presents an interesting example for a case study. If all the recent legislative efforts indeed turn out to be futile as this article expects, and the alternative ways suggested herein do not attract their attention for some reason, the only possible next step open for them might be a blatant override of the Treaty against the United States, which itself is a notorious champion of such practice. This is as far as the author can foresee for the time being, and only time will tell where this old tale will lead us to.

25. Art. 23 Enforcement Decree of the CITA.
26. Art. 27(2)(c) or (e) of the Treaty opens possibility for a mutual agreement on source-of-income issue, and this seems indeed the most appropriate way to end all this controversy.