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COMMENTS

COMPARATIVE ANALYSIS OF TRANSFER PRICING SYSTEMS IN THE UNITED STATES AND SOUTH KOREA

I. INTRODUCTION

The rise of multinational corporations (MNCs) within today's global economic structure has created interesting questions for countries world wide. MNCs use cross border parent-subsidary relationships to achieve greater efficiency, gain economies of scale, and exploit differences in national taxation rates.¹ These relationships provide flexibility in methods of distribution and in control of production costs.² The rise of MNCs has created the need for a system of taxation that can keep up with this changing global corporate environment.

In response to the changing global economy, countries have promulgated transfer pricing systems. Transfer pricing laws tax intercompany "sales of goods, the provision of services, the licensing of patents and know-how, and the granting of loans."³ The Internal Revenue Code section 482 contains the U.S. transfer pricing laws. The U.S. Treasury Department has also promulgated detailed regulations interpreting the basic provision.⁴

The complexity and prominence of MNCs today has prompted other countries to develop their own transfer pricing systems. South Korea (Korea) enacted new laws in December

1. See Don P. Yang, *Korean Group Predicts Proposed Transfer Pricing Regs. Will Have Unintended Consequences*, TAX NOTES INT'L, Aug. 2, 1993, at 483, available in LEXIS, Taxana Library, TNI File.

2. See Thomas Borstell, *Introduction: A Special Report Prepared by Thomas Borstell of Price Waterhouse, Dusseldorf*, INT'L TAX REV., Apr. 1997, at 4. Related entities within such MNCs generate more than half of the world's trade volume. See *Ernst & Young Transfer Pricing 1997 Global Survey*, WORLDWIDE TAX DAILY, Sept. 8, 1997, ¶ 4, available in LEXIS, Taxana Library, TNI File.

3. Suk Hi Kim, *International Transfer Pricing*, in READINGS IN INTERNATIONAL BUSINESS 420 (Robert Z. Aliber & Reid W. Click eds., 1993).

4. See, e.g., Treas. Reg. § 1.482-1 (1997).

1995 to bring its transfer pricing system up to par with current international standards.⁵ The new laws took effect on January 1, 1996.⁶ These new laws are found in the Law for the Coordination of International Tax Affairs (LCITA) and its accompanying Presidential Enforcement Decree (PED). Korea's laws are modeled after the Organization for Economic Cooperation and Development's (OECD)⁷ Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).⁸ Furthermore, the new rules update Korea's Corporation Tax Law (CTL), which primarily regulates domestic transactions.⁹

This Comment discusses the current developments in U.S. and Korean transfer pricing laws, relating specifically to tangible goods with occasional reference to laws regarding intangible goods. The Comment then analyzes the major differences and similarities of the two systems. The Comment also discusses some of the structural and economic factors that have compelled both countries to develop their particular transfer pricing systems. What emerges is a better understanding of the relative merits and flaws of each system. The Comment will occasionally make recommendations for change.

II. WHAT IS TRANSFER PRICING?

Transfer pricing represents the mechanism by which tax authorities levy adjustments to "clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions."¹⁰ A controlled transaction is a

5. See J.Y. Lee & S.L. Moller, *New Law Aims for Global Coverage*, INT'L TAX REV., Apr. 1996, at 19.

6. See Sai Ree Yun, *Korea's New Transfer Pricing Rules Favor 'Best Method' Approach*, 8 J. INT'L TAX'N 38 (1997).

7. See Jacques Sasseville, *The OECD Model Tax Convention Is Revised*, 4 J. INT'L TAX'N 129 (1993). OECD succeeded the Organization for European Economic Cooperation, which was set up to implement the Marshall plan after World War II. See *id.* The OECD works to carry out various international economic policies. See *id.*

8. See Yun, *supra* note 6, at 38.

9. See Lee & Moller, *supra* note 5, at 19. Using rules that primarily governed domestic corporations caused conflict among non-domestic parties. See *id.* CTL remains in effect for domestic transactions. See *id.* Korea's laws closely follow the heels of the July 1995 OECD Guidelines. See *id.*

10. Treas. Reg. § 1.482-1(a)(1) (1997). Because product comparability is most important when using methods such as the CUP, this distinction becomes especially important in these cases.

transfer of goods between related companies.¹¹ Controlled transactions rarely reflect the true taxable income attributable to two unrelated parties.¹² In contrast, an uncontrolled transaction involves a transfer of goods between unrelated parties.¹³ Parties to a controlled transaction may allocate a higher proportion of income to another related party in a relatively low tax jurisdiction.¹⁴

In effect, transactions between two related parties might not necessarily be at the market price.¹⁵ For example, a parent company in a high tax jurisdiction can avoid taxes by selling inventory at below market prices to its subsidiary in a low tax jurisdiction.¹⁶ When the subsidiary sells the goods, the resulting income is taxed at the lower rate of the subsidiary country locale and not the higher tax rate of the parent country. This artificially deflates the parent company's profit, ultimately minimizing its tax burden.¹⁷

Obviously, transfer pricing assumes that we should view two related companies as separate legal and economic entities.¹⁸ In contrast, MNCs argue that both entities constitute one economic unit.¹⁹

Economists have argued that "the ability to manipulate transfer prices is a major reason for the existence of multinational enterprises."²⁰ Potential for abuse exists because MNCs need to avoid foreign exchange controls and similar restrictions on the movement of international capital.²¹ Thus, countries must allocate sufficient time and resources to develop effective systems that will address the business requirements of the MNC without exacer-

11. See Masahiro Yoshimura, *The "Tax War" Between the United States and Japan Under Internal Revenue Code Sec. 482: Is There a Solution?*, 12 WIS. INT'L L.J. 401, 402 (1994).

12. See Eugene E. Lester, *International Transfer Pricing Rules: Unconventional Wisdom*, 2 ILSA J. INT'L & COMP. L. 283, 285-86 (1995).

13. See generally Sandra Reid Robertson, *Transfer Pricing Solutions in the Global Economy*, 3 ANN. SURV. INT'L & COMP. L. 177, 184 (1996) (describing the distinction between controlled and uncontrolled taxpayers).

14. See Derek Devgun, *International Fiscal Wars for the Twenty-First Century: An Assessment of Tax-Based Trade Retaliation*, 27 LAW & POL'Y INT'L BUS. 353, 360 (1996).

15. See Lester, *supra* note 12, at 286.

16. See generally Kim, *supra* note 3, at 408 (illustrating how a company can use transfer pricing to minimize its tax burden).

17. See *id.*

18. See *id.* at 413.

19. See *id.*

20. Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 90 (1995).

21. See Devgun, *supra* note 14, at 359-60.

bating the potential for abuse.

Some of the latest developments in the field reveal the potential for transfer pricing controversy between the United States and Korea. Lawrence Gibbs, the former IRS Commissioner, recently warned Korean companies operating in the United States that the IRS would toughen its implementation of transfer pricing laws.²² The IRS issued the warning notwithstanding the fact that Korean companies operating in the United States are generally not as profitable as other foreign rivals.²³ During his first presidential campaign, President Clinton singled out the issue of transfer pricing abuse by claiming that he would collect an additional forty-four billion dollars through taxing of MNCs.²⁴ As further evidence of support for such enforcement measures, Congressional members agreed that multinational companies were not paying their fair share of taxes.²⁵

Similarly, the Korean tax authorities recently announced plans to examine the transfer pricing practices of some 400 companies operating in Korea.²⁶ Companies under scrutiny would include large Korean corporations, foreign-invested companies, and local branches of foreign-owned companies.²⁷

III. UNITED STATES TRANSFER PRICING SYSTEM

The U.S. system of taxing MNCs has developed over a number of years. Since 1917, the Commissioner of Internal Revenue has had the authority to allocate income and deductions among affiliated entities.²⁸ The 1928 Revenue Act expanded this power.²⁹

22. See Yonhap, *Former IRS Official Warns Tougher Audits for Korean Cos.*, ASIA PULSE (Seoul), Apr. 8, 1997, available in LEXIS, News Library.

23. See *id.* In practical terms, Commissioner Gibbs announced that the IRS would use an audit technique called the "fragmented corporations" approach. Under this approach, the IRS must apply transfer pricing laws to companies doing business with one another. These transfer pricing laws, however, do not apply to commonly controlled companies. See *id.*

24. See Michael Avramovich, Note, *Intercompany Transfer Pricing Regulations Under Internal Revenue Code Section 482: The Noose Tightens on Multinational Corporations*, 28 J. MARSHALL L. REV. 915, 924-25 (1995).

25. See *id.* at 923-24. The remark was made by Congressional members in 1990. See *id.*

26. See Yong K. Kim, *Korean NTA Ready to Investigate Transfer Prices of 400 Companies*, WORLDWIDE TAX DAILY, Nov. 6, 1997, available in LEXIS, Library, 97 TNI 215-14.

27. See *id.*

28. See Sandra Reid Robertson, *Transfer Pricing Solutions in the Global Economy*, 3

In the 1960s, the IRS Commissioner increased its application of section 482 to transactions between U.S. taxpayers and their related foreign entities.³⁰

The recent promulgation of the Final Treasury Regulations (Regulations) in 1994, and the preceding Temporary and Proposed Regulations in 1993, resulted from a "White Paper" study produced by the Treasury Department.³¹ Congress initiated this study out of concern stemming from a desire to enact a more thorough system of transfer pricing administration.³² Many consider the resulting U.S. Regulations to be the most aggressive implementation of transfer pricing administration.³³

Under the U.S. Treasury Regulations, compliance with the arm's length standard determines the level of adjustments under section 482.³⁴ It states that "[a] controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances."³⁵

If the IRS determines that the company did not engage in an arm's length transaction, the IRS can make a corresponding adjustment.³⁶ If such an adjustment is made, the taxpayer can challenge its validity by proving, in court, that the IRS-imposed ad-

ANN. SURV. INT'L & COMP. L. 177, 181 (1996).

29. *See id.*

30. *See id.* at 181-82.

31. *See* Pamela L. Kayfetz & Leo B. Helzel, *Transfer Pricing: Achieving Fair National Taxation of International Transactions*, 3 ANN. SURV. INT'L & COMP. L. 193, 202 (1996). The White Paper outlined four key concepts:

1. At the time a tax return is filed, the taxpayer should document contemporaneous pricing or significant mispricing.
2. The IRS should aggressively pursue pricing information through administrative summons and Section 982 formal document requests. IRS economists and counsel should become involved early in the case.
3. The procedures for determining the appropriate transfer price of intangibles should be revised, and appropriate pricing readjustments should be made over time.
4. The rules for acceptable cost-sharing agreements should be made more specific. They should require an arm's length "buying" charge for preexisting unshared research.

Kim, *supra* note 3, at 417-18.

32. *See* Kayfetz & Helzel, *supra* note 31, at 202.

33. *See id.*

34. *See* Treas. Reg. § 1.482-1(b)(1).

35. *Id.*

36. *See* Treas. Reg. § 1.482-1(a)(2).

justments were "capricious, arbitrary or unreasonable."³⁷

The applicability of transfer pricing ranges from manufactured goods to intangibles such as patents, copyrights, and payments for professional or technical services.³⁸ Furthermore, section 482 targets two potential areas of tax avoidance. The first area focuses on U.S. taxpayers operating in "tax haven" jurisdictions.³⁹ The second area focuses on the U.S. operations of foreign multinational companies.⁴⁰

Despite the perceived abuses by MNCs with respect to inter-company transfer pricing, many have criticized the United States for its application of such vigorous standards against U.S. operations of foreign MNCs.⁴¹ Some argue that the large U.S. budget deficit has been the impetus in the implementation of the tougher standards that unduly burden such companies.⁴² As a result, potential claims of discrimination may arise.⁴³

Critics also warn that a strict enforcement policy is short-sighted. They claim that it does not take into consideration the long-term economic effects of a hostile business environment on foreign-owned MNCs.⁴⁴ Critics also assert that MNCs are more focused on business concerns, such as maximizing shareholder wealth, and are not concentrating on tax avoidance.⁴⁵ Such arguments, however, should not detract from the importance and magnitude of transfer pricing tax avoidance.

IV. KOREAN TRANSFER PRICING SYSTEM

Since 1996, Korean authorities may request MNCs to select and report "the most reasonable method" for producing an arm's length result.⁴⁶ Although tax authorities will not levy penalties for failure to report the method on a voluntary basis, they will gener-

37. Yoshimura, *supra* note 11, at 409.

38. *See id.*

39. *See id.* at 406.

40. *See id.* at 406-07.

41. *See generally* Avramovich, *supra* note 24, at 926-27.

42. *See id.*

43. *See generally* Devgun, *supra* note 14, at 355-56 (1996) (noting that claims of discriminatory practice occur when one jurisdiction does not treat citizens of another jurisdiction consistent with the expectations of the latter jurisdiction).

44. *See* Avramovich, *supra* note 24, at 926.

45. *See id.* at 928-29.

46. *See* PED art. 7(1).

ally not give that company favorable treatment.⁴⁷ Failure to voluntarily comply has two main consequences. First, auditors may place more priority on scrutinizing such taxpayers.⁴⁸ Second, in the event of an underreporting of income, companies that do not report “the most reasonable method” will not get the benefit of a waiver for penalties.⁴⁹ These unstated penalties will probably force many companies to comply with reporting requirements.

The Law for the Coordination of International Tax Affairs (LCITA), and its accompanying Presidential Enforcement Decree (PED) update Korea’s pre-existing Corporation Tax Law (CTL).⁵⁰ As mentioned earlier, the CTL mainly governed transactions with domestic implications.⁵¹ The CTL adjusts income from the domestic transaction when “the transaction unreasonably reduce[s] tax liability.”⁵² Previously, the domestic standard was also applied to international transactions. Subsequently, this system was updated to comply with international standards as the volume of cross border transactions involving Korean companies increased. The new international transfer pricing law required companies to use an arm’s length standard. The old domestic law, however, maintained the “unreasonable reduction” standard. Some have argued that this disparity might allow a party to claim “under domestic law, but not under the new law, that although a price is different from the prevailing market price, this has not unreasonably reduced tax liability.”⁵³

Although the United States utilizes a more rigorous transfer pricing system, Korea’s newly enacted laws have the potential for substantially increased enforcement of transfer pricing abuse. Despite such potential, as will be discussed subsequently, structural differences between the United States and Korea prevents the latter from enforcing its transfer pricing laws with the same level of rigor.

47. *See id.*

48. *See id.*

49. *See id.*

50. *See Lee & Moller, supra* note 5, at 19.

51. *See id.*

52. *Id.*

53. *Id.*

One such structural difference is the disparity in national economic output. Korea has used direct foreign investment as the engine of economic growth.⁵⁴ Relaxed transfer pricing regulations will facilitate continued foreign direct investment in Korea. As a result of its current financial crisis, increased pressure to attract foreign investment will play an important role in future transfer pricing policy. Furthermore, Korea can substitute other measures, such as foreign exchange controls, repatriation limits, and other foreign investment regulations, to control capital movement.⁵⁵

V. COMPARATIVE ANALYSIS OF TRANSFER PRICING SYSTEMS IN THE UNITED STATES AND SOUTH KOREA

A. Who Is Subject To Transfer Pricing Adjustments?

Under U.S. law, companies "owned . . . directly or indirectly by the same interests"⁵⁶ are subject to the provisions of Section 482.⁵⁷ Because ownership represents factual determinations, ownership is easier to determine than Section 482's standard of direct or indirect control by the same interests.⁵⁸ The U.S. Treasury Regulations provide that "control" includes any kind of control, "whether legally enforceable and however exercised."⁵⁹ A presumption of control also arises when companies shift income or deductions without adhering to the arm's length requirement.⁶⁰

Korea's LCITA provides that a "special relationship" exists between companies with cross ownership if:

- (1) [A] transaction party directly or indirectly owns fifty percent or more of the total number of shares entitled to vote in the other transaction party;
- (2) a third-party directly or indirectly owns fifty percent or more of the total number of shares entitled to vote in both the transaction parties; or
- (3) one transaction party can effectively decide business policy of the other

54. See generally Michael Happell, *Southeast Asia: A Special Report Prepared by Michael Happell of Price Waterhouse, Melbourne*, INT'L TAX REV., Apr. 1997, at 74 (arguing that more relaxed enforcement of transfer pricing laws against foreign companies encourage such companies to leave profits within those countries).

55. See *id.*

56. I.R.C. § 482 (1997).

57. See *id.*

58. See Robertson, *supra* note 28, at 183.

59. *Id.* (citing Treas. Reg. § 1.482-1(a)(3) (1995)).

60. See *id.* at 184.

transaction party.⁶¹

Despite such detail and broad scope, the LCITA does not clarify whether an entity such as the Korean permanent establishment of a foreign corporation would qualify as a related party.⁶² The current policy of Korean tax authorities is that a permanent establishment does not qualify as a related party.⁶³

B. Arm's Length As International Standard

Both the United States and South Korea tax codes contain mechanisms recognizing the arm's length principle, as promulgated by the OECD Guidelines,⁶⁴ as the proper standard for determining transfer pricing adjustments under each respective regime.⁶⁵ Criticism of the 1993 Regulations by taxpayers and foreign tax authorities forced the U.S. Treasury and IRS to work with the OECD Committee on Fiscal Affairs to develop a mutually consistent interpretation of the arm's length standard.⁶⁶ Under current U.S. law, the goal of using "the arm's length standard is met if the economic results of the 'controlled transaction'⁶⁷ are consistent with results that would have been obtained if uncontrolled taxpayers had engaged in a comparable transaction under comparable

61. LCITA art. 2(1) at 8.c.

62. See Yun, *supra* note 6, at 40.

63. See *id.*

64. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS 1.6 (1995) (stating that the authoritative statement of the arm's length principle is found in paragraph 1, article 9, of the OECD Model Tax Convention):

[When] conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Id.

65. See generally LCITA art. 5(1); see also Treas. Reg. § 1.482-1(b)(1) (enumerating the arm's length standard as the basis for transfer pricing adjustments). The United States has also included the arm's length standard in every income tax treaty. See 2 U.S. INTERNATIONAL TAXATION AND TAX TREATIES § 18.03[1] n.1 (1997).

66. See Henry J. Birnkrant & James E. Croker, Jr., *Transfer Pricing Final Regs. Increase Flexibility, But Not Certainty, in Choice of Method*, 81 J. TAX'N 268 (1994).

67. A controlled transaction is a transaction between two related parties. See 2 U.S. INTERNATIONAL TAXATION AND TAX TREATIES § 18.03[1] n.3 (1997) (citing Treas. Reg. § 1.482-1(i)(8)).

circumstances.”⁶⁸

Critics argue that such a standard represents a significant departure from the previous strict reliance on the use of comparable transactions under the arm's length standard.⁶⁹ In other words, the focus is not on the terms of the comparable transaction, but on reaching a comparable *result* irrespective of the terms.⁷⁰ This distinction means that an MNC can meet the goals of the arm's length standard without necessarily resorting to a method that employs the traditional standard of comparability.⁷¹ As discussed in greater detail below, this has significant ramifications for the systems in both countries.

Korea enumerates the arm's length price as “the price which is applied or determined to be applicable in an ordinary transaction by and between a resident, domestic corporation, or a domestic place of business and an unrelated party other than a foreign-related party.”⁷²

C. Establishment Of Best Method

Under U.S. law, the goal behind the best method concept is allowing the taxpayer to determine the “best” or most reliable method for determining an arm's length result.⁷³ This process can be costly and time-consuming. The taxpayer's hardship is compounded by the fact that the taxpayer is subject to second guessing by the tax authorities' idea of what constitutes the “best method.”⁷⁴ The “best method” language, along with its accompanying requirements, puts the taxpayer at the mercy of the tax authorities.

68. 2 U.S. INTERNATIONAL TAXATION AND TAX TREATIES § 18.03[1] (1997) (citing Treas. Reg. § 1.482-1(b)(1)).

69. See Avi-Yonah, *supra* note 20, at 145.

70. See *id.*

71. See *id.* Comparability is measured by comparing operating profit of companies in related business. If results are emphasized over profit, below market sales between related parties would be allowed.

72. Brian Park, *Korea: Variations on OECD Theme*, INT'L TAX REV., Feb. 1998, at 29.

73. See Treas. Reg. § 1.482-1(c)(1).

74. See 2 U.S. INTERNATIONAL TAXATION AND TAX TREATIES § 18.03[3][a].

In contrast to U.S. law, PED article 5(1) mandates that the taxpayer select the most “reasonable” method for an arm’s length transaction.⁷⁵ Initially, such language may reveal Korean authorities’ willingness to give more deference to the taxpayer’s choice of pricing method. Despite this appearance, the two systems are more alike than different.

1. Proof Of “Best Method” Through “Overpapering”

Section 482 requires that taxpayers prove through extensive documentation that a particular method is *not* the best method.⁷⁶ Korea’s PED does not require, however, what some call section 482’s “overpapering.”⁷⁷ PED article 7(1) merely requires the taxpayer to select the most reasonable method, and report the reasons for selection of this method.⁷⁸

In addition, section 482 requires a person to apply multiple analyses to establish that the rejected methods are not the best methods.⁷⁹ The Regulations’ standard states that a “taxpayer can reasonably conclude that a specified method provided the most reliable measure of an arm’s length result *only if* it has made a *reasonable* effort to evaluate the potential applicability of the other specified methods in a manner consistent with the principles of the best method rule.”⁸⁰ A reasonably thorough search for relevant data accomplishes this purpose.⁸¹

In applying such a standard, the amount of due diligence the taxpayer must perform is unclear.⁸² Moreover, the open-endedness of this requirement can pose problems for smaller taxpayers with limited resources.⁸³ Consequently, the taxpayer is subject to what tax authorities conclude is a “reasonable” search for relevant data.

75. See PED art. 5(1).

76. See Treas. Reg. § 1.6662-6(d)(2)(ii).

77. See Marc M. Levey & Lawrence W. Shapiro, *OECD Transfer Pricing Avoids Overpapering the Best Method*, 6 J. INT’L TAX’N 52, 54 (1995).

78. See PED art. 7(1). PED art. 5(1) seems consistent in this regard.

79. See Treas. Reg. § 1.6662-6(d)(2)(ii).

80. *Id.*

81. See *id.*

82. See generally Treas. Reg. § 1.6662-6(d)(2)(ii)(B). This section states that in “determining the scope of a reasonably thorough search for data, the expense of additional efforts to locate new data may be weighed against the likelihood of finding additional data that would improve the reliability.” *Id.* Such guidance seems quite subjective.

83. See Levey & Shapiro, *supra* note 77, at 54.

2. Criteria For Determination Of The Best Method

The criteria for determining the "best method" is common to both countries. For instance, U.S. law provides two basic factors for determining the best method: 1) the degree of comparability between the controlled and uncontrolled transactions;⁸⁴ and 2) the completeness and accuracy of available data and assumptions, and the sensitivity of the results to deficiencies in the data and assumptions.⁸⁵ Similarly, Korea's PED provides four basic factors for determining the best method. These criteria include: 1) the degree of comparability between the controlled and uncontrolled transactions; 2) the availability of data; 3) the high degree of conformity of assumptions between the controlled and uncontrolled transactions; and 4) the effect of deficiencies in data or assumptions on the arm's length price.⁸⁶

Both sides generally agree as to the standard of comparability for controlled and uncontrolled transactions. U.S. law refers to the standards as the sufficiency of similarity between the two transactions, as well as the applicability of adjustments for any deficiencies in comparability.⁸⁷ Korea's PED provides that the differences between controlled and uncontrolled transactions must not materially affect the comparison, and reasonably accurate adjustments can eliminate such material differences.⁸⁸ Despite the similarities, U.S. law appears to provide more flexibility by allowing the use of a comparison, even if their comparability is not high and reasonable adjustments do not eliminate material differences.⁸⁹ Conversely, Korea's PED does not provide for this added flexibility.⁹⁰

D. Types Of Arm's Length Methods

1. Comparable Uncontrolled Price Method

The comparable uncontrolled price method (CUP) evaluates price according to comparable goods or services transacted between independent parties that are identical or comparable to the

84. See Treas. Reg. § 1.482-1(c)(2)(i).

85. See *id.* at § 1.482-1(c)(2)(ii).

86. See PED art. 5(1).

87. See Treas. Reg. § 1.482-1(d)(2).

88. See PED art. 5(1).

89. See Treas. Reg. § 1.482-1(d)(2). Generally, such comparisons will not have a high degree of reliability. See *id.*

90. See PED art. 5(1).

controlled transaction in question.⁹¹ Under this approach, the U.S. Regulations stipulate that similarity of products between the controlled and uncontrolled transactions will have the greatest impact on the analysis.⁹² Because of this, the comparable uncontrolled price method is often difficult to implement accurately.⁹³

a. *Hierarchy of Methods*

As mentioned previously under the "best method" rule, the taxpayer must apply two factors: 1) the degree of comparability between the controlled and uncontrolled transactions; and 2) the quality of the data and assumptions used in the analysis.⁹⁴ With these two standards in mind, the Regulations do not specify a hierarchy or preference for one method of pricing over another:⁹⁵

[T]here is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used.⁹⁶

The Regulations indicate a slight preference for the CUP if the analysis is based on closely comparable uncontrolled transactions.⁹⁷ Under CUP, "uncontrolled sales are compared to controlled sales if their physical property and circumstances are nearly identical with the physical property and circumstances of controlled sales."⁹⁸ Some have argued that this method conveys the most accurate reflection of an arm's length price since it reflects "1) the price of sales made to unrelated customers; 2) the price of sales from unrelated sellers to the company; and 3) the price of sales between other unrelated parties."⁹⁹ Inherent in this concept

91. See Treas. Reg. § 1.482-3(b)(1); see also LCITA art. 5(1) at 1.

92. See Treas. Reg. § 1.482-3(b)(2)(ii)(A).

93. See *id.*

94. See Treas. Reg. § 1.482-1(c)(2).

95. See *id.* § 1.482-1(c)(1).

96. See *id.*

97. See Treas. Reg. § 1.482-1(c)(2)(i). "Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length." *Id.* § 1.482-1(c)(2).

98. Kim, *supra* note 3, at 413.

99. *Id.* "The comparable uncontrolled price is similar to the prevailing market price when markets are perfectly competitive. Section 482 allows an adjusted market price if

is the notion that the market acts as the most efficient and viable pricing system using inputs and outputs to set a market or arm's length price.

Korea takes a much different stance toward CUP than does the United States. PED article 5 states that when an uncontrolled transaction "with high degree of comparability . . . is identified, the CUP method . . . shall be considered as the method of determining arm's length price in priority over any other methods."¹⁰⁰ This strong language denotes a much clearer preference by the Korean authorities for the CUP method. Korean law favors use of CUP "if substantially the same products are sold under substantially the same circumstances, such as similarity in transaction period, level of market and terms of transactions."¹⁰¹ Differences should have no effect on price, or the taxpayer should be able to adjust for such differences.¹⁰²

The language gives a strong indication that Korean law, unlike its U.S. counterpart, establishes a hierarchy and preference for traditional transactional methods (e.g., comparable uncontrolled price, resale price, and cost plus methods) over transactional profit methods (e.g., profit split and transactional net margin methods).¹⁰³ Furthermore, LCITA article 5(1) provides that the "other" reasonable methods (i.e., profit split and transactional net margin methods) "shall only be used . . . if an arm's length price cannot be determined by . . . any of the [other] methods." This language is consistent with the OECD Guidelines, which stipulate that the transactional profit methods represent methods of "last resort."¹⁰⁴

markets are less than perfectly competitive." *Id.* at 413-14.

100. Kim, *supra* note 3, at 414. Such a strong preference for the CUP method, some have argued, ignores the fact that the method is often impractical to implement. One argument is that products sold within the group are so unique that outside markets for the goods do not exist. This makes it difficult to find comparables of uncontrolled transactions. *See id.*

101. Park, *supra* note 72, at 29.

102. *See id.*

103. *See* Yun, *supra* note 6, at 40.

104. *See* Frances M. Horner, *International Cooperation and Understanding: What's New About the OECD's Transfer Pricing Guidelines*, 50 U. MIAMI L. REV. 577, 589 (1996).

b. Practical Implications

Empirical evidence shows that the majority of MNCs in the world prefer to use transaction-based methods such as the comparable uncontrolled price or resale price methods.¹⁰⁵ These methods are preferable over profit based methods. The same is true when a method's frequency of use is grouped by the type of transaction between two subsidiaries.¹⁰⁶ To further distinguish between the two countries' laws, U.S. Regulations specifically provide that in situations where a sale of a tangible property includes some intangible property as well, it may be necessary to separate the comparability analysis.¹⁰⁷ This occurs where the sale of a tangible good might include such intangible rights as a trademark.¹⁰⁸ In such a case, the analysis must include similar comparable products.¹⁰⁹ In practice, this may be difficult to find because valuation of intangibles such as goodwill or trademarks are case specific and cannot be compared to other products or intangibles which are, by nature, not similarly situated. Korea's law does not provide an exception for this important distinction.

2. Resale Price Method

Both countries provide for the use of the resale price method (RPM). Under U.S. law, "[t]he resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review."¹¹⁰ "The appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin earned in comparable uncontrolled transactions."¹¹¹ Gross profit margin is expressed as a percentage of total revenue

105. See *Ernst & Young Transfer Pricing 1997 Global Survey*, *supra* note 2, ¶ 51.

106. See *id.* ¶ 55. Basic grouping of transactions can be in the form of tangible versus intangible goods or finished goods versus raw materials. See generally Kim, *supra* note 3, at 407 (noting the difference in classifications).

107. See Treas. Reg. § 1.482-3(f).

108. See *id.*

109. See *id.*

110. Treas. Reg. § 1.482-3(c)(2)(i). This method determines whether or not the price charged in the controlled transactions is arm's length by looking at the gross profit margin of a comparable uncontrolled transaction. See *id.* § 1.482-3(c)(1). This method is often used when the taxpayer purchases and resells goods without any significant alteration of the good's value. See *id.*

111. Treas. Reg. § 1.482-3(c)(2)(iii).

derived from sales.¹¹²

Korea's RPM states that "an arm's length price of an asset refers to the price computed by subtracting an appropriate mark-up amount from the price that a related party, who purchased the asset from another related party, would have received from an independent uncontrolled party."¹¹³ Tax authorities compute an appropriate mark-up by "applying the selling-based normal profit rate to the purchaser's resale price to an uncontrolled party."¹¹⁴ The selling-based normal profit rate represents "the gross profit rate realized by the purchaser from a transaction with an uncontrolled party."¹¹⁵

Similarities between the two countries exist in the use of the RPM. For example, Korea's law stipulates that the taxpayer shall not significantly alter the value of the good resold.¹¹⁶ This is an important provision since the addition of significant value prior to resale will make computing the resale profit margin more difficult. Restriction of added value allows authorities to determine the resale profit margin with relative ease. U.S. Regulations contain a similar restriction.¹¹⁷

U.S. law, like Korean law, stipulates that in deriving comparable gross profit margins, taxpayers should use their own purchases and resales in comparable, uncontrolled transactions.¹¹⁸ A more accurate comparability analysis results from using the same taxpayer's controlled and uncontrolled transactions.¹¹⁹ If the taxpayer cannot find such comparables, it can look to other resellers.¹²⁰

U.S. application of the RPM represents more of an operating profit analysis rather than a gross profit analysis.¹²¹ In other words, the analysis has to make appropriate adjustments for func-

112. *See id.*

113. LCITA art. 5(1).

114. PED art. 8(1).

115. *Id.*

116. *See Park, supra* note 72, at 29. Under the Treasury Regulations, substantial alteration does not include "packaging, repackaging, labeling, or minor assembly." *See* Treas. Reg. § 1.482-3(c)(1).

117. *See* Treas. Reg. § 1.482-3(c)(1).

118. *See id.* § 1.482-3(c)(3)(ii); *Park, supra* note 72, at 30.

119. *See id.* § 1.482-3(c)(3)(ii).

120. *Id.*

121. *See* Marc M. Levey et al., *Japan's Transfer Pricing System Is Evolving Along U.S. Lines*, 4 J. Int'l Tax'n 407, 410 (1993).

tions performed and risks assumed.¹²² Korea's PED article 6(2) also provides for similar adjustment of profit margins.¹²³ Unlike U.S. rules,¹²⁴ however, Korea's PED does not enumerate the specific types of adjustments to gross profit margins.¹²⁵

A notable difference between the two laws involves intangible products or services. The Treasury Regulations mention that "the resale price method is not ordinarily used in cases where the controlled taxpayer uses its intangible property to add substantial value to the tangible goods."¹²⁶ It also specifically excludes the resale price method from its list of enumerated methods for intangibles.¹²⁷

In contrast, Korea's PED stipulates that "the resale price method . . . may be applicable to transactions of services or other international transactions, if it is required to do so in order to reasonably determine an arm's length price."¹²⁸ Such language does not preclude using the resale price method on transactions involving intangible goods.

3. Cost Plus Method

Under U.S. law, the cost plus method "evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit markup realized in comparable uncontrolled transactions."¹²⁹ This is done by adding an appropriate gross profit to the controlled taxpayer's costs of production.¹³⁰ "The appropriate gross profit is computed by multiplying the controlled taxpayer's cost of producing the transferred property by the gross profit markup"¹³¹ U.S. law expresses the appropriate

122. *See id.* "[T]he advertising and warranty expenses borne by a distributor and the issue of who owns the U.S marketing intangibles may cause adjustments to gross margins resulting in something closer to operating margins." *See id.*

123. *See* PED art. 6(2).

124. *See* Levey et al., *supra* note 121, at 409.

125. *See generally* PED art. 6(2) (enumerating that reasonable adjustments should be made for differences in functions performed, risks assumed and contractual conditions).

126. Treas. Reg. § 1.482-3(c)(1).

127. *See id.* § 1.482-4(a). This section enumerates only the comparable uncontrolled transaction method, comparable profits method, profit split method, and unspecified methods. *See id.*

128. PED art. 6(3).

129. Treas. Reg. § 1.482-3(d)(1).

130. *See id.* § 1.482-3(d)(2).

131. *Id.* § 1.482-3(d)(2)(ii).

gross profit as a percentage of cost.¹³² The cost plus method applies when related parties are involved in the sale of manufactured, assembled, or other produced goods.¹³³

Under U.S. regulations, the taxpayer should determine the appropriate gross profit markup by reference to its own uncontrolled comparable transactions.¹³⁴ As with RPM, the justification of the cost plus method is that the taxpayer will more likely find similar characteristics among its own uncontrolled transactions.¹³⁵ Korea has also added this provision.¹³⁶

Korea's law stipulates that "an arm's length price . . . refers to the price computed by adding the appropriate mark-up amount to the cost incurred in purchasing, manufacturing or providing the assets or services for the purpose of selling or providing the same asset or service to a related party."¹³⁷ The appropriate mark-up amount is "computed by applying the cost-based normal profit rate to the cost incurred by a seller of assets in purchasing, constructing or manufacturing at a normal price."¹³⁸

Both the U.S. Regulations and Korea's provisions¹³⁹ specifically provide for physical product comparability. In contrast, under the CUP method, physical comparability is not provided for and physical comparability is less important under the cost plus method.¹⁴⁰ What is more important is that of functional comparability.¹⁴¹

4. Comparable Profits Method

Unlike section 482,¹⁴² the LCITA and PED wholly exclude the comparable profits method (CPM).¹⁴³ Article 4 of the PED

132. *See id.*

133. *See* Treas. Reg. § 1.482-3(d)(1).

134. *See id.* § 1.482-3(d)(3)(ii)(A).

135. *See id.*

136. *See* Park, *supra* note 72, at 30.

137. LCITA art. 5(1).

138. PED art. 8(2).

139. *See* Park, *supra* note 72, at 30.

140. *See* Treas. Reg. § 1.482-3(d)(3)(ii)(B).

141. *See id.* § 1.482-3(d)(3)(ii)(A).

142. *See* Treas. Reg. § 1.482-3(a) (authorizing use of CPM).

143. *See* LCITA art. 5(1) (providing for the use of comparable uncontrolled price method, resale price method, cost plus method, and other reasonable methods provided by the Presidential decree); *see also* PED art. 4 (stipulating that the "other reasonable methods" referred to in LCITA art. 5 are the profit split method, the transactional net margin method, and other methods that are considered reasonable). *See* PED art. 4.

contains explicit inclusion of only the profit split method (PSM) and the transactional net margin methods (TNMM) within the "other" methods category. This further supports the view that Korean authorities intentionally excluded CPM.

The United States often uses CPM because of a lack of ability to obtain transaction-based data for applying other methods, such as the resale price or cost plus methods.¹⁴⁴ The CPM "evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances."¹⁴⁵ Profit level indicators are the ratios between profits and costs incurred or resources employed.¹⁴⁶ Examples of this include the rate of return on capital employed,¹⁴⁷ operating profit to sales,¹⁴⁸ and gross profit to operating expenses.¹⁴⁹

a. Trends In International Community

Why does Korea disfavor use of CPM? Is this disfavor warranted? Some have pointed to the fact that countries with greater experience in applying traditional transaction methods are more aware of the difficulties accompanying such methods.¹⁵⁰ These countries show more willingness to resort to transactional profit methods¹⁵¹ (e.g., comparable profit, profit split methods). Meanwhile, developing countries are only now beginning to experience the difficulties associated with applying traditional transaction methods.¹⁵²

A similar trend may occur within Korea's transfer pricing system. Perhaps the difference in view regarding CPM simply arises from the fact that Korea's system, like many other less-developed systems, has not had the same amount of time to develop.

144. See Levey et al., *supra* note 121, at 411.

145. Treas. Reg. § 1.482-5(a).

146. See *id.* § 1.482-5(b)(4).

147. See *id.* § 1.482-5(b)(4)(i).

148. See *id.* § 1.482-5(b)(4)(ii)(A).

149. See *id.* § 1.482-5(b)(4)(ii)(B).

150. See Happell, *supra* note 54, at 74. Writers have noted that the difficulties of finding comparables in relation to such areas as performance functions or product similarity may make resorting to profit methods more likely. See Birnkrant & Croker, Jr., *supra* note 66, at 332.

151. See Birnkrant & Croker, Jr., *supra* note 66, at 332.

152. See *id.*

b. *Criticism From The International Community*

Korea is not alone in its disfavor of CPM. The OECD compromised with the United States regarding the question of CPM as an internationally viable method.¹⁵³ OECD documents show that CPM is a method of "last resort."¹⁵⁴ Not only do the OECD documents consider the CPM as a secondary method, they explicitly discourage its use.¹⁵⁵

The international community has two main criticisms of the use of CPM. First, critics argue that the method is not based on the arm's length principle. In other words, they maintain that the arm's length standard should be based on a transactional approach, which looks at the price, not at the profitability of the transaction.¹⁵⁶ This criticism recognizes that two unrelated firms will set their prices in accordance with market conditions, and not with respect to the profitability of other parties.¹⁵⁷ Because firms cannot control external market conditions,¹⁵⁸ the market price is an accurate measure of an arm's length transaction.¹⁵⁹ These critics also argue that profitability is determined by internal factors that vary widely between companies.¹⁶⁰ The second criticism of

153. See Borstell, *supra* note 2, at 5. Korea may argue that its position has the backing of the OECD. The problem with this argument, however, is that the OECD's Guidelines do not bind any country. See *id.* at 5.

154. See Birnkrant & Croker, Jr., *supra* note 66, at 333. Such last resort status would make comparability less important for use of CPM than for other transaction methods. See *id.*

155. See *id.* at 332. The language of the documents states that:

There are . . . cases where transaction-based methods cannot be applied alone. These would be considered cases of last resort In such cases of last resort, practical considerations may suggest application of a profit-based method either in conjunction with transaction-based methods or on its own. Nevertheless, for the reasons set out in this report . . . as a general matter the use of profit methods is discouraged.

Id.

156. See Sven-Olof Lodin, *Is the American Approach Fair? - Some Critical Views on the Transfer Pricing Issues*, in *ESSAYS ON INT'L TAX'N* 265, 266 (Herbert H. Alpert & Kees Van Raad eds., 1993).

157. See *id.* at 268.

158. See *id.* at 266.

159. See generally *id.* (noting that prices determined by market conditions are equal for all competitors).

160. See *id.* at 266. Internal factors that have dramatically different effects on profitability include salary cost level, productivity, transportation cost, rate of turnover, local labor, safety legislations, management skill, organization of work, skill and training levels, automation, R&D levels, effectiveness of advertising, and marketing success. See *id.* at 266-67.

the use of CPM is that it is not in line with international practices.¹⁶¹

Furthermore, critics specifically opposed to the use of CPM on Korean MNCs note that the special makeup of Korea's huge conglomerates, commonly referred to as "chaebol," makes it impracticable to apply this method. The sheer size of Korean chaebol enables them to internalize costs and produce goods more cheaply through economies of scale than can smaller U.S. domestic companies.¹⁶² Critics claim that CPM is based on "an unrealistic assumption that all companies in [a] similar industry will and should attain the same level of performance over long periods."¹⁶³ The very nature of business competitiveness, the argument goes, is that some firms will outperform others within the same industry. By applying a rigid standard for measuring the comparability of profits, CPM might be ignoring the competitive advantage chaebol enjoys as a result of cross industry relationships. Additionally, CPM ignores the alternative impetus for business transactions that occur in the chaebol other than profit.

Despite such criticism, the use of CPM has its advantages. For example, the method incorporates proven financial ratios,¹⁶⁴ such as operating profit to sales and gross profit to operating expenses.¹⁶⁵ Financial ratios represent universally accepted measures that transcend particular industries. Transactional differences also have less of an affect on CPM than on traditional transactional methods such as CUP.¹⁶⁶

c. *Double The Cost Of Compliance*

The difference in view between the United States and Korea puts a taxpayer doing business in both countries at the risk of double compliance costs.¹⁶⁷ A Korea-based MNC may need to apply the CUP method even though it doesn't qualify as the "best method" under U.S. law.¹⁶⁸ Similarly, the IRS may require the use

161. See *id.* at 268.

162. See generally Yang, *supra* note 1, at 483 (noting that huge Korean companies known as "multi-national import-export companies" have such a characteristic).

163. *Id.*

164. See Levey & Shapiro, *supra* note 77, at 58.

165. See Treas. Reg. § 1.482-5 (b)(4)(ii)(A)-(B).

166. See Levey & Shapiro, *supra* note 77, at 58.

167. See Lodin, *supra* note 156, at 269.

168. See Charles F. Connolly, *The New Transfer Pricing and Penalty Regulations: Increased Compliance, Increased Burdens, and the Search for a Safe Harbor*, 16 U. PA. J.

of CPM as the "best method" even though Korea does not recognize it.¹⁶⁹ To comply with both systems, the competing tax authorities may require an MNC to use two different methods.¹⁷⁰ Such problems can double the cost of compliance¹⁷¹ and highlight the need for more consistency and cooperation between the two countries' systems.

d. What Could Korea Do?

One practical barrier to Korea's use of CPM might be the availability of data. Sufficient data represents one of the crucial determinants of an appropriate profit level indicator.¹⁷² This could be a serious problem for companies in Korea where financial information is not as readily available for outside use.¹⁷³ Even when such information is available, it is not always in electronic form, making its use inefficient.¹⁷⁴ The U.S. Regulations underscore this practical barrier by stipulating that "profit level indicators based solely on internal data may not be used because they are not objective measures of profitability derived from operations of uncontrolled taxpayers."¹⁷⁵

Despite the structural difficulties, Korea should consider the practical difficulties of finding strict comparable transactions and resort to a more flexible approach when it comes to the CPM. Korea's strict standard of comparability restricts use of the CPM. In this regard, Korea could adopt the U.S. approach of making the "degree of functional comparability required to obtain a reliable result under the comparable profits method less than that required under the resale price or cost plus methods."¹⁷⁶

INT'L BUS. L. 339, 355-56 (1995).

169. *See id.* at 356. Despite the practical conveniences in applying CPM, Korea's advantage is the support of the OECD and a majority of the international community in not applying CPM.

170. *See id.*

171. *See id.*

172. *See* Treas. Reg. § 1.482-5(b)(4).

173. *See generally* Yang, *supra* note 1, (noting that the database of company information is *generally* not available or applicable to taxpayers' situation).

174. *See* Park, *supra* note 72, at 32.

175. Treas. Reg. § 1.482-5(b)(4)(iii). In other words, U.S. law does not allow the use of the taxpayer's own internal data to determine the CPM. It does, however, allow for the use of the taxpayer's own internal data in computing comparables for other methods such as the resale price or cost plus methods. *See id.* § § 1.482-3(c)(3)(ii)(A) to -3(d)(3)(ii)(A).

176. *Id.* § 1.482-5(c)(2)(ii).

If Korea bases its disfavor of the use of CPM on the criticism that the method is inconsistent with the arm's length standard, the disfavor is unwarranted. For instance, the profit split method, as mentioned below, does not rely on the strict use of comparable transactions.¹⁷⁷ Despite this fact, Korean law allows for its use. An inconsistency exists if this is the reason for Korea's rejection of CPM.

Korea could also develop an approach where it allows for use of CPM if, upon demand by the authorities, the taxpayer cannot produce sufficient records to determine an arm's length approach under one of the other methods.¹⁷⁸ This may be a practical solution to the problem of finding strict comparables under the other above-mentioned methods.¹⁷⁹

5. Profit Split Method

Korean and U.S. laws both provide for the use of another profit method, known as the profit split method (PSM).¹⁸⁰ The PSM involves two different approaches. These include the comparable PSM¹⁸¹ and residual PSMs.¹⁸²

Under U.S. law, "[t]he profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss."¹⁸³ Korea's provision of the PSM is similar in scope.¹⁸⁴

177. See Avi-Yonah, *supra* note 20, at 146. Avi-Yonah states that the "residual profit split method is clearly not within the traditional arm's length standard because it does not rely on comparables in making the crucial determination about splitting the residual." *Id.*

178. See Levey et al., *supra* note 121, at 410. Japanese authorities use this approach. See *id.*

179. See *id.* at 411. Transactions such as CUP are sometimes rare. See *id.* Data also may not be sufficiently available for applying the resale or cost plus methods. See *id.*

180. See Treas. Reg. § 1.482-6; PED art. 4. Korean authorities give preference among transactional profit methods to the profit split method over the transactional net margin method. See Yun, *supra* note 6, at 40.

181. See Treas. Reg. § 1.482-6(c)(2).

182. See *id.* § 1.482-6(c)(3).

183. Treas. Reg. § 1.482-6(a).

184. See generally PED art. 4. "This method is to allocate the combined net operating profit derived by both parties in an international transaction between a resident . . . and its overseas related party . . . based on the relative value of each party's contribution to the combined profit . . ." *Id.*

The comparable PSM approach, under U.S. law, allocates the combined operating profit by looking at the operating profit of uncontrolled taxpayers.¹⁸⁵ The taxpayer compares the relative profit percentage of the uncontrolled taxpayers to its own profit, and then allocates the profit from its controlled transaction accordingly.¹⁸⁶

U.S. law also allows for the use of a residual PSM. The taxpayer can use this approach where either party to the transaction owns significant intangible property.¹⁸⁷ The intangibles may produce a residual profit that is higher than the profit resulting from the parties' routine functions.¹⁸⁸ In applying the PSM to such cases, the taxpayer first allocates the routine operating income to each controlled party by using the combined operating profit allocation of comparable uncontrolled taxpayers.¹⁸⁹ The taxpayer must use a functional analysis to determine the contributions according to "functions performed, risks assumed, and resources employed by each of the controlled taxpayers."¹⁹⁰

Once the taxpayer establishes the above, the U.S. Regulations require the taxpayer to determine the residual profit split.¹⁹¹ Basically, this involves determining which party bore the expenses for developing the intangible good.¹⁹² In other words, the residual profit split allows the controlled taxpayer to single out profit attributable to valuable intangibles that uncontrolled taxpayers might not own.¹⁹³ In this step, the taxpayer divides the residual profit among the controlled taxpayers.¹⁹⁴ This is done according to the value of each controlled party's relative contribution.¹⁹⁵

Korean law allows the taxpayer to apply either a contribution or residual analysis.¹⁹⁶ Under the contribution analysis, "the combined net operating profit . . . would be divided between the re-

185. See Treas. Reg. § 1.482-6(c)(2)(i).

186. See *id.*

187. See Avi-Yonah, *supra* note 20, at 146.

188. See *id.* These routine functions are "contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns." Treas. Reg. § 1.482-6(c)(3)(i)(A).

189. See Treas. Reg. § 1.482-6(c)(3)(i)(A).

190. *Id.*

191. See Treas. Reg. § 1.482-6(c)(3)(i)(B).

192. See Avi-Yonah, *supra* note 20, at 146.

193. See Treas. Reg. § 1.482-6(c)(3)(i)(B).

194. See *id.*

195. See *id.*

196. See Yun, *supra* note 6, at 40.

lated parties based on the relative value of each party's contribution to the combined profit."¹⁹⁷ The combined profit could be the total profit from the transaction or a residual profit that cannot be readily assigned.¹⁹⁸ The method then allocates the relative contribution on the basis of uncontrolled parties.¹⁹⁹ Under a residual analysis, the taxpayer allocates an appropriate portion of basic income from its basic transaction type.²⁰⁰ The method then allocates the remaining residual profit.²⁰¹

The two sides are similar in the language that deals with the factors used in the contribution analysis. For instance, U.S. law stipulates that the "relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity."²⁰² In similar fashion, Korean law stipulates the factors as:

[T]he amount of expenses disbursed or to be disbursed for purchasing, manufacturing or selling assets or rendering services; the amount of capital expenditure incurred, the total value of assets used or risks assumed in developing assets or rendering services; the functions performed at each stage of the transaction; and other reasonable measurable allocation criteria.²⁰³

Some claim that PSM represents a departure from a strict dependence on comparable transactions.²⁰⁴ Unlike the comparable profit method, the residual PSM approach looks only to the profitability of the MNC under examination, and not to other "comparable" entities.²⁰⁵ For instance, the taxpayer does not have to rely on a comparable uncontrolled transaction when splitting the residual profit.²⁰⁶ In this regard, PSM does away with the difficulty of

197. *Id.*

198. See Park, *supra* note 72, at 30.

199. See Yun, *supra* note 6, at 40.

200. See *id.* at 41.

201. See *id.*

202. Treas. Reg. § 1.482-6(b).

203. PED art. 4 at 1.a-1.d.

204. See Avi-Yonah, *supra* note 20, at 146.

205. See ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), TAX ASPECTS OF TRANSFER PRICING WITHIN MULTINATIONAL ENTERPRISES, THE UNITED STATES PROPOSED REGULATIONS IN OECD DOCUMENTS 3.12 (1993).

206. See Avi-Yonah, *supra* note 20, at 146.

finding comparables similar to the taxpayer, which is especially difficult in areas such as managerial efficiency.²⁰⁷ Because of such factors, the method may deviate from the traditional requirements of an arm's length transaction.²⁰⁸

E. Documentation

1. Level Of Documentation Required

The level of documentation required under the two systems represents an important distinction. Taxpayers may use such documentation as proof that they determined the transfer price under the reported method.²⁰⁹ The U.S. system requires the taxpayer to produce documents in existence at the time the taxpayer filed the return.²¹⁰ In contrast, article 11 of LCITA and article 19 of PED do not mention such a requirement. Although article 19 does mention the kind of information that the tax authorities may request,²¹¹ the provision merely limits the scope of such information.²¹²

This distinction between the kind and scope of information is important for the MNC. Under U.S. law, the contemporaneous documentation requirement can be tremendously burdensome and time-consuming.²¹³ The Korean law more closely resembles the OECD's approach,²¹⁴ which does not require contemporaneous documentation.²¹⁵ The drafters of the OECD Guidelines believed that taxpayers would be overburdened by such an approach.²¹⁶ Although tax authorities may require proof during audit, Korea's provision does not impose any penalties for failure to keep contemporaneous documentation.²¹⁷ LCITA does, however, require an MNC in Korea to submit detailed information regarding certain

207. See OECD, *supra* note 205, at 3.12.

208. See *id.*

209. See I.R.C. § 6662(e)(3)(B)(i)(II).

210. See *id.*

211. See PED art. 19.

212. See *id.* PED art. 19 (limiting the scope of documents the tax authorities may request).

213. See generally Marc M. Levey & Lawrence W. Shapiro, *OECD Transfer Pricing Draft Targets Excessive Documentation*, 6 J. INT'L TAX'N 244, 248 (1995).

214. See generally *id.*; Cf. LCITA art. 11 and PED art. 19.

215. See Park, *supra* note 72, at 32.

216. See Levey & Shapiro, *supra* note 213, at 249.

217. See LCITA art. 11; see also PED art. 19.

transactions with related overseas parties.²¹⁸ As a practical matter, this may force MNCs in Korea to keep contemporaneous documentation.²¹⁹

2. Time Requirement

The Korean law also shows greater flexibility in the time it gives the taxpayer to comply with the tax authorities' request for documentation. Article 11(3) of LCITA provides the taxpayer sixty days to comply with a request.²²⁰ Tax authorities have the discretion to grant an extension of another sixty days if the taxpayer presents a justifiable reason.²²¹ In contrast, Internal Revenue Code (I.R.C.) section 6662(e)(3) authorizes a thirty day limit for similar requests.²²² A thirty day notice might prove somewhat burdensome, especially considering the complexity of today's MNCs. As a consequence, the sixty days provided by the LCITA better reflects the needs of today's business environment.

3. Differences in Policy

Between the two countries, the United States has a more proactive approach to document production.²²³ In requesting documentation, U.S. authorities do not have the burden of establishing a presumption of transfer of profits abroad.²²⁴

Such differences also explain why some companies may have problems providing proper documentation to the IRS.²²⁵ If an affiliate of a Korean company operates in the United States, U.S. authorities may require the company affiliate or the Korean company to adhere to stricter documentation standards than those in Korea.²²⁶

218. See LCITA art. 11(1).

219. See Park, *supra* note 72, at 32.

220. See LCITA art. 11(3).

221. See *id.*

222. See I.R.C. § 6662(e)(3)(B)(II).

223. See Marc M. Levey & Pierre-Sebastien Thill, *Transfer Pricing in France Moves Closer to the U.S. Approach*, 7 J. INT'L TAX'N 388, 393 (1996).

224. See *id.*

225. See *id.*

226. See *id.*

F. Exceptions To Use Of Penalty Provisions

Under certain circumstances, both systems provide exception to their respective penalty provisions.²²⁷ Under the U.S. rules, the taxpayer must show that "there was a reasonable cause . . . and that the taxpayer acted in good faith" in determining the taxable income.²²⁸ The exception has both an objective and subjective component.²²⁹ The objective element deals with the possession and use of documentation.²³⁰ This element examines: 1) the experience and knowledge of the taxpayer, including all members of the taxpayer's controlled group; and 2) the extent to which the taxpayer had access to reliable data and analyzed it in a reliable manner.²³¹ The taxpayer can also take into consideration the cost of additional efforts in obtaining new data.²³² The subjective element requires the taxpayer to go through multiple analyses to determine that the applied method represents the most reasonable method.²³³

The U.S. standards make successful invocation of the penalty exception provision extremely difficult.²³⁴ With such stringent requirements, a taxpayer may have difficulty avoiding penalties.

Korea's transfer pricing laws also provide for an exception to its penalty provisions.²³⁵ Use of the exception requires the following: 1) the taxpayer presents the procedure for arriving at the most reasonable method; 2) the taxpayer actually uses the method selected; and 3) the taxpayer keeps the necessary data and information related to the method.²³⁶ The law does not mention a re-

227. See PED art. 23; see also Treas. Reg. § 6664(c).

228. Treas. Reg. § 6664(c). Before this exception can apply, the taxpayer must meet an additional requirement as set forth in Treas. Reg. § 1.6664-4T(d) which states that a "taxpayer that does not satisfy the rules of section 1.6662-6(d) for a net section 482 adjustment cannot satisfy the reasonable cause and good faith exception under section 6664(c)." Connolly, *supra* note 168, at n.105.

229. See Connolly, *supra* note 168, at 360.

230. See *id.*

231. See Treas. Reg. § 1.6662-6(d)(2)(ii)(A) and (B); see also Birnkrant & Croker, Jr., *supra* note 66, at 272.

232. See Treas. Reg. § 1.6662-6(d)(2)(ii)(B); see also Birnkrant & Croker, Jr., *supra* note 66, at 272.

233. See *id.* Treas. Reg. § 1.6662-6(d)(2)(ii).

234. See generally Connolly, *supra* note 168, at 272. Connolly argues that the Regulations "require overly broad searches and are not clear as to how great a self-compliance effort a taxpayer must undertake to avoid penalties." *Id.*

235. See PED art. 23.

236. See *id.*

quirement of multiple analyses.²³⁷ As a result, the taxpayer seems to have a much better chance of invoking the penalty avoidance exception.

G. Advance Pricing Agreements

Both the U.S. and Korean transfer pricing systems allow taxpayers to use advance pricing agreements (APAs). APAs represent formal agreements between tax authorities and taxpayers that, for a fixed period of time, predetermine the method of the arm's length price.²³⁸ MNCs that use the APA process note that such arrangements provide certainty to the taxpayer.²³⁹ APAs can also help avoid double taxation and costly examinations.²⁴⁰ Although APAs provide potential benefits to the parties involved, they come with significant investments of time and money.²⁴¹ Thus, the large multinational company with substantial resources is more likely to take advantage of the APA provisions,²⁴² thereby, putting the relatively smaller companies at a disadvantage.

Korea's APA arrangement details significant conditions by which the tax authorities can cancel APAs. The law stipulates that authorities can cancel APAs in the event that revision of relevant laws or regulations render contents of the APA inappropriate.²⁴³ If authorities can cancel an APA under the stipulated conditions, taxpayers may consider the risk of cancellation too great a cost. Although the same provision does allow the taxpayer to change the affected portions of the APA,²⁴⁴ it is questionable whether this provides adequate protection. The value of the APA within Korean transfer pricing is subject to scrutiny. The ability of tax authorities to cancel APAs will hurt MNCs who rely on such agreements for prolonged periods of time. If authorities can cancel agreements on the aforementioned grounds, companies might consider the risk too great.

237. See *id.*

238. See LCITA art. 6; see also Kayfetz & Helzel, *supra* note 31, at 210.

239. See Kayfetz & Helzel, *supra* note 31, at 210.

240. See Ernst & Young, *supra* note 2, ¶ 27.

241. See *id.*

242. See Birnkrant & Croker, Jr., *supra* note 66, at 272.

243. See PED art. 13(1).

244. See *id.* art. 13(3).

H. Differences In Political And Business Cultures

The differences in content and scope of the laws in the United States and South Korea might have their roots in structural differences that stem from political, economic, and cultural norms. In other words, countries have different structural reasons for implementing particular systems of taxation.

1. Comparison Of Political Cultures

Some writers note that the major difference separating Pacific Rim nations from Western nations is the disparity of coordination between a nation's tax policy and its industrial policy.²⁴⁵ For example, governments in Pacific Rim countries implement tax policies that are in close coordination with economic policies.²⁴⁶ This allows them to indirectly guide a corporation's business strategy.²⁴⁷ In contrast, American political culture mandates the importance of a free-enterprise system.²⁴⁸ As a result, corporations operate in a much more decentralized political environment than their Asian counterparts.²⁴⁹

Why are these differences important for implementing transfer pricing laws such as section 482? A simple answer does not exist. Nonetheless, exploring the overall effects of a stringent transfer pricing system, or tax policy for that matter, will uncover the impact on economic competitiveness.

Strict enforcement of transfer pricing may impact foreign direct investment.²⁵⁰ For example, a decrease in foreign direct investment will subsequently decrease the value of a nation's currency.²⁵¹ Although a weakened currency provides for increased exports, it also increases real interest rates as demand for investments decrease.²⁵² Overall, a decrease in available capital impacts the amount of capital available for a nation's debt reduction.²⁵³

245. See Karen V. Kole, *Tax Concerns for Pacific Rim Multi-nationals Doing Business in the United States*, 25 U.S.F. L. REV. 449, 452 (1991).

246. See *id.* at 453.

247. See *id.*

248. See *id.*

249. See *id.*

250. See Kole, *supra* note 245, at 458.

251. See *id.* at 459.

252. See *id.*

253. See *id.*

This illustrates the need for a transfer pricing system that takes a country's economic goals into consideration. If a nation is serious about attracting foreign direct investment, a system more favorable to MNCs will benefit such a goal.²⁵⁴ In support of this assertion, Korea's current dependence and focus on attracting foreign investors will play a key role in formulating its tax policies. Although it is a generalization to say that the United States is not as dependent on foreign investment, we can see the contrast in focus between the two countries. Furthermore, Korea's centralized approach to economic policy-making creates an environment where government can synthesize various competing policies. It is true, however, that the U.S. system provides evidence of a strong democracy at work.

2. Comparison Of Business Cultures

The difference in business cultures of the East and West represents another important distinction. The Japanese *keiretsu*, or vertically integrated companies, present a prime example of this distinction.²⁵⁵ *Keiretsu* are normally centered around a parent company or bank institution²⁵⁶ with interlinking ownership.²⁵⁷ This ownership takes the form of "interlocking directorates, presidential councils, group-member shareholding, lending preferences, few intra-group competitors, and intra-group grading."²⁵⁸ Member firms have tremendous advantages in loan accessibility, reduced interest rates, and access to distribution systems.²⁵⁹ Despite Japan's Anti-monopoly Act, the country's industrial policy favors huge monopolistic ventures that center around incredibly strong parent companies.²⁶⁰ This directly contrasts with U.S. anti-monopoly policy, which promotes competitive markets.²⁶¹ This policy difference creates difficulty for the U.S. application and enforcement of section 482.²⁶² For example, establishing the element of direct or indirect control proves difficult.²⁶³ Without this de-

254. See *id.* at 461.

255. See Robertson, *supra* note 28, at 189.

256. See *id.* at 187.

257. See *id.*

258. *Id.* at 187-88.

259. See *id.* at 188.

260. See *id.* at 189.

261. See Robertson, *supra* note 28, at 189.

262. See *id.*

263. See *id.* It is not easy to establish control. See *id.*

termination, a basis for a section 482 investigation does not exist.

The significance of the problem in applying section 482 adjustments to the *keiretsu* is informative. The *keiretsu's* structure, although different in many respects, is similar to the Korean model of conglomerate companies known as *chaebol*.²⁶⁴ *Chaebol* companies share many of the characteristics of *keiretsu* companies. The interlocking ownership between member firms of the *chaebol* and the *keiretsu* represent one such similarity.²⁶⁵ Much like Japan's government, Korea's government has actively fostered monopolistic development of *chaebol* companies through access to preferential loans by state-influenced banking institutions²⁶⁶ and a preferential regulatory environment.²⁶⁷ During early periods of economic development, both the Japanese and Korean governments fostered particular industries.²⁶⁸

Such cultural preferences impact transfer pricing adjustments. Because Japan and other Asian countries favor a producer-oriented society,²⁶⁹ those countries place greater emphasis on the manufacturing process.²⁷⁰ This directly contrasts with consumer-oriented countries such as the United States,²⁷¹ which inevitably places more emphasis on marketing than on manufacturing.²⁷²

The practical impact of such differences is that a Japanese or Korean manufacturer with a U.S. distribution subsidiary, will allocate more of its profits to the manufacturing process than to the distribution process.²⁷³ A Japanese or Korean MNC's reliance on manufacturing more likely makes the profit of such a company subject to the U.S. practice of IRS adjustment.²⁷⁴ These differ-

264. See MYUNG H. KANG, THE KOREAN BUSINESS CONGLOMERATE 63 (1996). Early form of Japanese companies known as zaibatsu was broken up by the Supreme Command of Allied Powers ("SCAP") after World War II. See *id.* at 72. Keiretsu, or a vertically-integrated company, emerged post WWII. See *id.* at 74.

265. See Yoshimura, *supra* note 11, at 420. "A consistent dividends payment among member corporations maintains prosperity within the group." *Id.*

266. See SOON CHO, THE DYNAMICS OF KOREAN ECONOMIC DEVELOPMENT 36 (1994).

267. See *id.*

268. See *id.* The Korean government targeted certain areas such as heavy, chemical, and export-oriented industries. See *id.* at 42.

269. See generally Levey et al., *supra* note 121, at 408.

270. See *id.*

271. See *id.*

272. See *id.*

273. See *id.*

274. See generally Levey et al., *supra* note 121, at 408.

ences show the importance of understanding the structural differences that potentially play an important part in transfer pricing.²⁷⁵

Furthermore, foreign subsidiaries of Japanese companies are prone to shift income to their parent companies in Japan.²⁷⁶ The motivation for such transfer of income is not tax-avoidance, but "business reasons related to corporate strategy, such as improving financial statements."²⁷⁷ The subsidiary's relative lack of bargaining power plays a role in such profit transfers.²⁷⁸

These observations are informative for our discussion of the *chaebol*. Especially as recent events make *chaebols* strapped for sources of financing,²⁷⁹ parent companies might increasingly choose to sacrifice their subsidiaries' profitability for the good of the parent.²⁸⁰

This raises the interesting question of whether or not tax authorities, such as the IRS, should consider the business and financial motivations of *chaebols* in making appropriate transfer pricing adjustments. This becomes even more important in light of Korea's recent financial problems.

VI. CONCLUSION

The complexity of today's MNCs necessitates increasingly complex transfer pricing systems that will keep in step with the MNCs. Although the potential for tax avoidance is great, tax authorities in the United States and Korea must also remember that companies are principally in business to make a profit and not to avoid taxes. A fair and adequate system will keep this crucial point in mind when implementing rules. A balanced approach to taxation that factors in this important element will find adherents and proponents throughout the world community. This does not, however, negate the potential for income shifting.²⁸¹

275. *See id.*

276. *See* Yoshimura, *supra* note 11, at 417.

277. *Id.*

278. *See id.* at 417-18.

279. *See id.* at 418.

280. *See* Kim, *supra* note 3, at 410. Strong financial statements increase the likelihood of securing financing for cash-strapped Korean companies. *See id.*

281. *See id.* at 408.

As a body of law, Korea's transfer pricing system lacks the complexity and detail of its U.S. counterpart. We do see, however, a system that is not far behind in scope and concept. We also see a system that is fairly close in line with Korea's current economic objectives. Korea's transfer pricing laws show an effort to implement internationally-accepted principles of taxation. Despite its current day economic problems, Korea's transfer pricing system will continue to develop along international standards.

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