

Interpretation of the Royalty Provision of the South Korea-United States Tax Treaty: From South Korea's Perspective*

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Abstract

The purpose of this article is to provide interpretative guidance to readers outside of South Korea for the royalty provisions of the South Korea-U.S. tax treaty from South Korea's perspective. This article reviews the royalty provisions of the tax laws and the South Korea-U.S. tax treaty and the issue of characterization. To clarify the meaning of royalties, this article analyzes the differences between royalties and other income. Characterization issues arising from the transfer of computer software are also considered. The South Korea-U.S. tax treaty adopts the place of use rule. The Korean domestic tax laws prescribe both the place of use rule and the place of payment rule, as well as impose taxation on unregistered intangible property. This article reviews and analyzes the history of the source provision and the Korean Supreme Court decisions that pertain thereto. From South Korea's perspective, if a patent is registered only in the United States or elsewhere, not in South Korea, consideration for the use of such a patent does not fall within the South Korean source royalties under the South Korea-U.S. tax treaty, even though the provision of the domestic Korean tax law provides otherwise.

KEY WORDS: royalties, tax treaty, source, characterization, place of payment, place of payment, patent

Manuscript received: Apr. 23, 2017; review completed: May 11, 2017; accepted: May 19, 2017.

* This study was financially supported by Chonnam National University, 2016.

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I. Introduction

The purpose of this article is to examine the meaning of royalties and the South Korean source rule thereto in the application of the South Korea-United States tax treaty and to provide interpretative guidance to overseas (outside of Korea) readers for the royalty provisions of the South Korea-U.S. tax treaty.

Since the source rule, taxable income and tax rate, tax exemption, and withholding are determined according to how certain income is characterized, it is crucial to correctly characterize the income incurred by a foreign individual or corporation into the relevant income category as prescribed in the tax treaty or domestic law. This is especially true with regard to transactions involving intangible property, since the income derived from such transactions may take several forms, such as royalties, gains, or personal service income.

The South Korea-U.S. tax treaty and the Korean tax laws define royalties as payments made in consideration for the use of intangible property or know-how as prescribed there. However, since the nature of intangible property makes it difficult to distinguish sales from licensing transactions and services contracts, to clarify the meaning of royalties, this article analyzes the differences between royalties and other income. To this end, in order to get some interpretative guidance in the application of the tax treaty in South Korea, American case law is reviewed in addition to that of South Korea.

Unlike most developed countries, which tax royalties only in the beneficial owner's residence, South Korea applies the source rule to tax royalties. Two-source rules generally apply to royalties: one is the place of residence of the payer and the other is the place of use. South Korea adopts the place of residence of the payer in most of its tax treaties. The South Korean tax laws prescribe both of them. However, the South Korea-U.S. tax treaty employs only the place of use rule.

The meaning of the term "use" in the tax treaty is not clearly explained anywhere in the tax treaty or domestic laws. The South Korean source royalty income has been an issue, particularly with regard to consideration for the use of patents that are not registered in South Korea. Thus, this

article tries to clarify the meaning of the term “use” and other related issues by reviewing and analyzing statutes and case law.

II. What is a Royalty? (*Characterization of Income*)

To decide where the source of royalties is, whether certain income is royalty income should first be determined. This issue of characterization is addressed in this part.

1. *Overview of the Royalty Provisions of Tax Law and Tax Treaty*

Article 14(4) of the South Korea-United States tax treaty¹⁾ defines royalties as

(a) Payment of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, copyrights of motion picture films or films or tapes used for radio or television broadcasting, patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights, or knowledge, experience, or skill (know-how), or ships or aircraft (but only if the lessor is a person not engaged in the operation in international traffic of ships or aircraft); and (b) Gains derived from the sale, exchange, or other disposition of any such property or rights (other than ships or aircraft) to the extent that the amounts realized on such sale, exchange, or other disposition for consideration are contingent on the productivity, use, or disposition of such property or rights.

The South Korean tax law defines royalties as including (a) payment of any kind made as consideration for the use of (i) copyrights of literary, artistic, or scientific works including cinematography films, patents, trademarks, design or model, plan, secret formula or process, film and

1) United States – Republic of Korea Income Tax Convention, art. 14(4), June 4, 1976, 30 U.S.T. 5253.

tapes for radio and television broadcasts, or other like property or rights; (ii) information or know-how related to industrial, commercial, or scientific knowledge and experience; (b) gains derived from the alienation of any property, rights or information described above(a).²⁾

The United States Tax Code describes royalties as including (a) payment for the use of or for the privilege of using patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property.³⁾ If the payments made in consideration for any sale of intangible property are contingent on the productivity, use, or disposition of such intangible property, such payments are considered royalties.⁴⁾

2. Characterization Issue- Distinguishing between Royalties and Other Income

Since consideration received in transactions involving intangible property may take several forms such as royalties, gains, or personal service income and, due to the nature of intangible property, it is not easy to distinguish between royalties and other income. Even though the tax treaty and tax law define royalties by illustrating items of royalties, the concept of royalties is not self-explanatory. By understanding the differences between royalties and other income, the concept of royalties can be better understood.

1) Royalties versus Service Income

(A) South Korea

• Tax authorities' position

Regarding whether certain income is royalty income or service income, the South Korean tax authorities have published the following ruling:

If an engineer provides services by utilizing professional knowledge or

2) Beobinse-beop [Corporate Tax Act] (hereinafter CTA), Act No. 14386, Dec. 20, 2016, art. 93(8); Sodeukse-beop [Income Tax Act] (hereinafter ITA), Act No. 14474, Dec. 27, 2016, art. 119(10).

3) Internal Revenue Code (hereinafter IRC), 26 U.S.C., § 861(a)(4) (2012).

4) IRC §§ 865(d)(1)(B) (2012), 871(a)(1)(D) (2012), and 881(a)(4) (2012).

skills that are generally held by other service providers in a similar kind of occupations, such services (“technical support services”) must be regarded as personal service, and fees received in consideration for such technical support services must be treated as personal service income to the recipient.⁵⁾ On the other hand, if the professional knowledge or skills are not generally held by other service providers in a similar kind of occupations, fees received must be considered royalties received in consideration for know-how or information as prescribed in Article 93(8) of the CTA.⁶⁾ To determine whether the income derived from the use of information or know-how is royalty income, the following factors must be weighed:⁷⁾

(i) Whether a confidentiality clause exists in a service contract or a special device in the program to prevent disclosure of confidential information.

(ii) Whether compensation for technological services significantly exceeds the sum of the actual costs incurred in rendering service and normal profits.

(iii) Whether a service provider is required to play a particular role in a user’s application of the information or know-how provided or guarantees the result thereof.

- Case Law

The Supreme Court of South Korea has also accepted this position of the tax authorities. For instance, in its 87Nu1050 (May 9, 1989) ruling, the Court accepted the above position of the tax authorities.⁸⁾ A, a South Korea’s resident, run a business to furnish military supplies and to render services for the United States army stationed in South Korea. A wanted to acquire the techniques or skills to operate remote controlled airplane models used

5) Beobinse-beop Gibontongchik [The Basic Rulings of Corporate Tax Act], Established Rule of National Tax Service, May 20, 2014, art. 93-132-7(2).

6) *Id.* at art. 93-132-7 (3)

7) *Id.*

8) *See also* Supreme Court, 2015Du950, June 24, 2015; Supreme Court, 86Nu212, Oct. 28, 1986.

for anti-aircraft-firing exercises. Accordingly, he entered into a training service agreement for technique or skill transfer with B, a United States corporation that had no permanent establishment in South Korea.

According to the agreement, B's employees trained A's employees at A's work sites in how to remotely control, maintain, install, and operate remote controlled airplane models, and A paid a certain amount of service fees to B. The Appellate Court found that such service fees are equivalent to the amount of actual expenditures that B made for its employees working in South Korea as their airfares, lodging, dining, and wages, that such service fees do not comprise consideration for know-how, and further that remote controlled airplane models are similar in their structures and operation to those used by students or ordinary people in South Korea.

Based on these findings, the Appellate Court held that the payments that B received in consideration for rendering services in South Korea were not royalties as provided in Article 14(4) of the South Korea-US tax treaty, but instead constituted personal service income as provided in the CTA. The Court reasoned that that training services that B provided for A are generally held by other service providers in a similar kind of occupation, that the training services are ancillary and subordinate to the principal purpose of A's business, which is to supply model airplanes to the U.S. Army, even though some technical information (know-how) was transferred in the training services and that the payments made for the training services were not paid in consideration for know-how, but were in reality reimbursements of actual expenditures made for airfares, lodging, dining, and wages of B' employees. The Supreme Court affirmed this decision of the Appellate Court.

- Summary

In South Korea, the rules on characterization of technical service fees have been promulgated by tax authorities and accepted by the Supreme Court. However, beyond the technical service fees, there is no clear guidance to determine whether certain income is royalty income or service income. The American case law related to the creation of intangible property may give some guidance to solve a similar issue in South Korea.

(B) United States Case Law

If the right to use such property is granted to another party after a taxpayer (creator) performs services and creates intangible property, such as a patent, trade process, or other property interest, then a characterization issue arises whether the resulting payments to the creator are royalties or service income. The essential distinction between royalties and service income is whether the creator is obligated under the contract to create certain intangible property and, on its creation, whether the property right thereto belongs to somebody other than the creator.⁹⁾ If the creator is obligated to create property and to turn over all rights therein to another with no ownership interest in the underlying property to the creator, the amounts paid to the creator constitute service income.¹⁰⁾ In what follows, some of the leading cases that deal with this matter are presented.

In *Ingram v. Bowers*,¹¹⁾ the singer, Enrico Caruso, who was a nonresident alien, had entered into contracts with the Victor Talking Machine Company to sing for phonograph records at the Company's studios in the United States. Caruso's compensation under the contracts was 10 percent of the list price on all records sold. The contracts labeled this compensation as royalties. The Court of Appeals in *Ingram* concluded that, under the terms of the contracts, Caruso never obtained any interest in the matrices or the records produced. Therefore, in the case of Caruso's compensation for records sold by the Company or the foreign licensees in foreign countries, the issue was whether Caruso's compensation referred to as royalties was royalty income. The *Ingram* court held that Caruso's income was entirely U.S.-source personal service income, as he had no interest or copyright in the matrices or the records sold.

In *Karrer v. United States*,¹²⁾ the Court of Claims reached a similar conclusion in the context of patentable property created by an inventor's personal efforts. In *Karrer*, the taxpayer, who was a nonresident alien, Swiss

9) See generally JOSEPH ISENBERGH, *INTERNATIONAL TAXATION* 57-60 (3d ed. 2010). See also PHILIP F. POSTLEWAITE, ET.AL, *FEDERAL INCOME TAXATION OF INTELLECTUAL PROPERTIES & INTANGIBLE ASSETS* ¶ 14.02(3) (2016).

10) See generally JOEL D. KUNTZ & ROBERT J. PERONI, *U.S. INTERNATIONAL TAXATION* ¶ A2.03(6) (e)(i) (2016). See also PHILIP F. POSTLEWAITE, ET.AL, *supra* note 9.

11) *Ingram v. Bowers*, 57 F.2d 65 (2d Cir. 1932), *aff'g*, 47 F.2d 925 (SDNY 1931).

12) *Karrer v. United States*, 152 F. Supp. 66 (Ct. Cl. 1957).

scientist, and professor of chemistry, entered into agreements with a Swiss drug company to provide vitamin research to the company. Under the terms of the agreements and the Swiss law, the taxpayer and the Swiss drug company made a contract which might be designated as a special employment contract under the terms of which all patents resulting from the taxpayer's discoveries belonged to the Swiss drug company. The U.S. patents on the discoveries of the scientist, who was considered the taxpayer, were registered in the taxpayer's name according to the requirements of U.S. patent law and then transferred to an American corporation, which, in turn, directly paid the taxpayer the percentage of the proceeds from the sale of the vitamins in the United States based on the agreements between the taxpayer and the Swiss drug company. The Court held that the payments received by the taxpayer from the American corporation were foreign-source personal service income for research services performed in Switzerland. The Court reasoned that the drug company was the owner of the property rights to the taxpayer's discoveries. Consequently, the payments that the taxpayer received from the American corporation were compensation for his performing research services for the drug company.

Finally, the facts of *Boulez v. Commissioner*¹³⁾ are in many ways similar to the facts in *Ingram* and the Tax Court reached a result similar to *Ingram* and *Karrer*. In *Boulez*, the taxpayer, a nonresident alien and resident of Germany, was a musical conductor who made recordings under a contract with CBS Records, a division of CBS United Kingdom, Ltd., which was a subsidiary of CBS, Inc., an American corporation. Pursuant to the contract with CBS Records, the taxpayer conducted various performances in the United States to record musical compositions for CBS Records. The copyrights underlying the musical compositions that he conducted were registered in the name of CBS, Inc. CBS, Inc. compensated the taxpayer by paying his agent based on a percentage of the receipts from sales of the records.

The Tax Court in *Boulez* held that the payments that the taxpayer received were compensation for personal services, not royalties, as the result of which the treaty exemption for royalties did not apply. The *Boulez*

13) *Boulez V. Commissioner of Internal Revenue*, 83 T.C. 584 (1984).

Court concluded that the taxpayer had no copyrightable right in the recordings; that is, he was engaged to make the recordings in question. Consequently, his contract with CBS Records reserved no property rights in the recordings to him and all such rights were held by CBS Records.

- Application in South Korea

South Korea does not have any precedent to solve the issues similar to those that arose in the American cases outlined above. Therefore, their interpretation could provide guidance to resolving similar issues in South Korea. If the facts in *Ingram* and *Boulez* arise in South Korea, and the South Korean copyright law applies, the taxpayers in *Ingram* and *Boulez* would have property rights to the recordings in South Korea, which they could either license or sell. Under the South Korean copyright law, a performer, for instance, a singer as in *Ingram* or a conductor as in *Boulez* has neighboring rights,¹⁴⁾ which consist of property rights and moral rights (personal rights)¹⁵⁾ similar to the rights of an author (creator) in copyrights.¹⁶⁾ Unlike in the United States, the “works for hire” rule is not applicable in South Korea.¹⁷⁾ Exceptionally, an employer may have a copyright for works made by a dependent employee during the course of the employee’s duty in South Korea.¹⁸⁾ Thus, the results in both cases are not applicable in South Korea.

By contrast, the result in *Karrer* would be identical in South Korea, since, under the patent law of South Korea, the taxpayer in *Karrer* may transfer his entitlement to a patent before he obtains a patent in his name.¹⁹⁾ If so, he has no patent right to discoveries and, consequently, the compensation received

14) Jeojakgwon-beop [Copyright Act] (hereinafter CRA), Act No. 14634, Mar. 21, 2017. art. 2, subpar. 4; and art. 64.

15) Regarding the concept of “moral rights”, see, e.g., Robert C. Bird & Lucille M. Ponte, *Protecting Moral Rights in the United States and the United Kingdom: Challenges and Opportunities under the U.K.’s New Performances Regulations*, 24 B.U. Int’l L.J. 213 (2006).

16) See CRA arts. 66-77.

17) See 17 U.S.C. § 101 (2012) (defining “work made for hire”). See also *Community for Creative Non-Violence v. Reid*, 490 U.S. 730 (1989) (analyzing 13 specific factors to determine whether a hired person is an employee under the common law of agency).

18) CRA art.2 (31) and art. 9.

19) The Patent Law (Teukheobeop) of S. Korea art. 37 (2016).

is not royalty income in South Korea either.

(C) When Payments Are Mixed Together with Royalties and Personal Service Income

According to the rulings of the South Korean tax authorities, payments made in consideration for the services by a technical service contract that provides “technical support services” and information (know-how) must be apportioned as follows:²⁰⁾

(i) If either technical support service or know-how constitutes the principal element of the contract and the other is ancillary and subordinate, the total consideration from such a service contract is characterized based on the characterization of the principal one.

(ii) If neither technical support service nor know-how constitutes a dominant portion of such a contract, the total consideration must be allocated to each based on reasonable standards, such as the quantity of consideration from the know-how provided, working hours, or weekly wages.

This characterization was accepted by the South Korean Supreme Court.²¹⁾ These rulings by the tax authorities deal with service fees related to technical support services. Other than technical support services, South Korea does not have any clear standard as described earlier.²²⁾

From the perspective of the United States, if there is no clear method to allocate service fees between royalties and personal service income, such fees should be allocated between the two considering all facts and circumstances.²³⁾

20) Beobinse-beop Gibontongchik [The Basic Rulings of Corporate Tax Act] CTA, art. 93-132-7(4).

21) See Supreme Court, 2015Du950, June. 24, 2015; Supreme Court, 87Nu1050, May. 9, 1989.

22) See *supra* part II. B.1.(A).

23) See *Goosen v. Commissioner*, 136 T.C. 547 (2011) (the taxpayer, Goosen, was a professional golfer and U.K. resident, who received endorsement fees through endorsement agreements allowing several sponsoring companies to use his name and likeness throughout the world. The endorsement fees were in the nature of off-course and on-course endorsement

2) *Sale of Intangible Property- Issue on Contingent Payment*

- Provision of the tax treaty

Article 14(4)(b) of the South Korea-U.S. tax treaty provides that gains derived from the disposition of intangible property listed in Article 14(4)(a) of the treaty or rights thereto are considered royalties to the extent that the amounts realized on such disposition for consideration are contingent on the productivity, use, or disposition of such property or rights. Said differently, all dispositions of listed intangible property or rights are not always royalties and only gains derived from contingent payment disposition are royalties. If the amounts realized are not contingent payments, taxation on such gains is decided according to Article 16 (capital gains) of the South Korea-U.S. tax treaty.^{24) 25)}

- America's perspective

Under the U.S. tax law, if payments are contingent, gains from the sale of intangible property are sourced in the same way as royalties²⁶⁾ and contingent payments for the sale of intangible property are treated as

fees, endorsement bonuses, and ranking bonuses. The commissioner and the taxpayer did not argue regarding the point that the endorsement fees under the off-course endorsement agreements constituted royalty income. The Tax Court in *Goosen* reconfirmed the rule that the payments for the right to use a person's name and likeness are royalties, as the person owns the right. The Court ruled that characterization of the taxpayer's on-course endorsement fees and bonuses depends on whether the sponsors primarily paid for the taxpayer's services, for the use of the taxpayer's name and likeness, or for both. After finding that there was no method to allocate the endorsement fees, the *Goosen* Court allocated the endorsement fees equally between royalties and compensation for personal services). Compare *Goosen* with *Garcia v. Commissioner*, 140 T.C. No. 6 (2013) (allocating 65 percent of endorsement fees to royalties and 35 percent to compensation for personal services, where the issue was the characterization of the endorsement fees of a professional golfer).

24) See TECHNICAL EXPLANATION OF THE 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, SIGNED AT SEOUL ON JUNE 4, 1976, art. 14(4), available at www.irs.gov/pub/irs-trty/koreatech.pdf.

25) According to Article 16 of the S. Korea-U.S. tax treaty, capital gains from the disposition of intangible property may be exempt.

26) See IRC § 865(d) (2012).

royalties for withholding tax purposes.²⁷⁾ Accordingly, the provision of Article 14(4)(b) of the treaty dealing with the disposition of intangible property is generally consistent with the provisions of America's domestic tax law. Therefore, contingent payment refers to a continuing payment measured by a percentage of the selling price of the products marketed, or based on the number of units manufactured or sold, or based in a similar manner upon production, sale, use, or disposition of the property or interest transferred, excepting the payment certain as to the amount to be received, but only contingent as to the time of payment or an installment payment of a principal sum agreed upon in a transfer agreement.²⁸⁾

• South Korea's perspective

The Korean version of "disposition for consideration are contingent on" in the treaty may be read differently, since the Korean version uses, as a counterpart term of "contingent", such terms that may not convey the meaning of "contingent" as understood by English readers.²⁹⁾

In this regard, the South Korean tax authorities take the position that a single lump sum payment in full at the sale of intangible property is also a royalty, if the payment is calculated based on future cash flow from the property sold.³⁰⁾ The National Tax Tribunal affirmed this position,³¹⁾ the basis for which is that future cash flow is calculated based on the productivity, use, or disposition of the sold property. No court decisions have been found on this matter.

• Suggestion for Revision and Interpretation

This position with regard to the interpretation and application of contingent payments has many defects. From the economic perspective, a

27) See IRC §§ 871(a)(1)(D) (2012), 881(a)(4) (2012).

28) Treas. Reg. § 1.871-11(a) (2016).

29) See Korean version, art. 14(4)(b) (providing that in Korean "그러한 재산 또는 권리(선박 또는 항공기는 제외됨)의 매각, 교환 또는 기타의 처분에서 발생한 소득 중에서 동 매각, 교환 또는 기타의 유상처분으로 취득된 금액이 그러한 재산 또는 권리의 생산성, 사용 또는 처분에 상응하는 부분") (emphasis is added).

30) See, e.g., Jaekukjo-64, May. 16, 2008; Jaekukjo 46017-91, June. 8, 2002; Beobkyukujo2013-12, April. 5, 2013.

31) See, e.g., Tax Tribunal, Josim2014Seo0202, April. 15, 2014.

selling price is the sum of future cash flow, which is calculated deservedly reflecting the productivity, use, etc. of the sold property. Therefore, if this position of the Korean tax authorities applies to the South Korea-U.S. tax treaty, all payments from sales of intangible property listed in the tax treaty will be treated as royalties, which is apparently contrary to both countries' intent when they negotiated and concluded the treaty. In addition, mere full lump sum payments at one time without reserving any legal and economic future interest in the property sold do not imply any meaning of "contingent."³²⁾ Consequently, the position of the Korean tax authorities should be changed to reflect the countries' intent; furthermore, the appropriate Korean counterpart of the English term "contingent" should be interpreted as having the meaning of the English word "contingent." At this point, the meaning of contingent payments as provided in the Treasury Regulation of the United States³³⁾ can serve as guidance when interpreting the meaning of contingent payments in South Korea. Ultimately, it is more desirable that the counterpart term in Korean of "contingent" should be revised to convey a clear meaning to reflect the intent of the two countries.

3) *License versus Sale*

Even though gains from sales of intangible property are not treated as royalties, except for contingent payments, whether the transfer of intangible property is a sale or a license remains an issue. South Korea has no statute or case law in this respect. In South Korea, the following interpretation could be acceptable: A transfer is treated as a sale if there is a transfer of all or substantial rights; otherwise, the transfer of intangible property is treated as a license.³⁴⁾

4) *Software*

Whether the proceeds from the transfer of a computer program are royalties is at issue. The characterization of the payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular

32) See generally JOSEPH ISENBURG, *supra* note 9, at 96-7.

33) See *supra* note 28.

34) See generally, JOEL D. KUNTZ & ROBERT J. PERONI, *supra* note 10, ¶ A2.03(7)(d)(i).

arrangement regarding the use and exploitation of the program.³⁵⁾ The rights in computer programs are a form of intellectual property.³⁶⁾

- Position of tax authorities

The South Korean tax authorities provide the following guidelines to determine whether the payments made in consideration for the transfer of computer software are royalties.³⁷⁾

a. The following payment must be treated as royalties received in consideration for the use or sale of copyrights underlying software.

(i) When the payment is consideration for the transfer of the ownership to the rights in the copyrights underlying the software; or (ii) when the payment is consideration for the use of or the right to reproduce, distribute, or modify the software.³⁸⁾

b. Other than the above, the payment from the following must be treated as royalties received in consideration for the use of know-how underlying software.

(i) When a software provider provides confidential source code; (ii) when software is produced or modified in accordance with the transferee's specific request in case of not providing confidential source code; and (iii) when the payments made in consideration for software are charged on the rule set based on the use of software, such as the method of use or quantity of reproduction.

- Case law

This position of the tax authorities related to b. above is enshrined in the

35) See the OECD Model Tax Convention on Income and on Capital, commentary on art. 12 ¶ 12.2 (2014).

36) See *Id.*

37) Beobinse-beop Gibontongchik [The Basic Rulings of Corporate Tax Act] art. 93-132-8(2), (a) through (c)

38) But see the OECD Model Tax Convention on Income and on Capital, commentary on art. 12 ¶15 ("Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty").

decision of the South Korean Supreme Court;³⁹⁾ however, regarding a(i) above, the position of the Supreme Court is not certain, since no decision dealing with a(i) above can be found.⁴⁰⁾

In the 97Nu4005 (Dec.12, 1989) ruling of the Supreme Court of South Korea, the Court accepted the position of the tax authorities. The Court ruled that, generally, when software is sold or used in South Korea, as it was imported from abroad without being given reproduction rights, the software should be considered imported as goods, not as know-how or the transfer of the technology, and also ruled that, if a software provider provides a confidential source code, or if software is produced or modified in accordance with the transferee's separate order in case of not providing a confidential source code, or if the payments made in consideration for software are charged on the rule set based on a certain rule related to the use of software, then the import of such software is know-how or the transfer of the technology.

A, a Korean domestic corporation had imported software used for workstations and micro stations from B, a U.S. corporation with no permanent establishment in South Korea, and sold such software to end-users in South Korea.

The Court found that, in its functions and quality, the software had no separate independent function; it played auxiliary roles in the end-users' business. The Court also found that the end-users purchased the software to improve their work efficiency, but there was no separate technical support or technology transfer, that the software was not provided a confidential source code to understand how the software works, that many programs were already competing with this software and the prices were standardized, that the end-users had bought the software in the condition in which it was in when it was imported by A, that no software had been produced or modified according to the end-user's separate order, and that the unit price of the software at issue was fixed when the software was transferred to the end-users.

39) *See, e.g.*, Supreme Court, 97Nu4005, Dec. 12, 1989; Supreme Court, 97Nu11065, Jan. 21, 2000.

40) However, the Supreme Court considered the above a(ii) as know-how related royalties, not as copyright related royalties. *See* Supreme Court, 97Nu4005, Dec. 12, 1997.

Based on the conclusions and findings specified above, the Court held that the software at issue was not know-how, but goods.

- Compare to the American rule and implications

The Treasury Regulation of the U.S. prescribes the characterization of income derived from transactions of computer software.⁴¹⁾ Since the provisions of the regulation are more comprehensive and detailed than those of South Korea, the provisions of the regulation may comprise all provisions of South Korea. However, consideration paid for the transfer of the ownership of the rights in the copyright underlying software is treated as a royalty in South Korea. By contrast, in the United States, the transfer of all substantial rights in the copyright is not treated as a royalty; instead, it is considered a sale or exchange of property.⁴²⁾ Furthermore, while, from American perspective, when the ownership of the rights in software is transferred, Article 14 of the South Korea-US tax treaty is not applicable, from South Korea's perspective, the Article may be applicable.

41) See Treas. Reg. § 1.861-18 (2016). Briefly summarized as follows: A transaction involving the transfer of a computer program generally can be classified into (i) a transfer of a copyright right; (ii) a transfer of a copyrighted article; (iii) services for the development of programs; or (iv) know-how related to computer programming techniques. 1. A transfer is considered a transfer of a copyright right if, as a result of the transaction, a transferee acquires any one of the following rights: (i) to make copies of the program for distribution to the public by sale or other transfer of ownership or rental, lease or lending; (ii) to prepare derivative computer programs; (iii) to make a public performance of the program, or (iv) to publicly display the program. 2. A transfer is considered a transfer of a copyrighted article if, as a result of the transfer, the transferee does not acquire any of the rights set forth in 1. above, the transfer involves only a *de minimis* provision of services, and the transfer involves only a *de minimis* provision of know-how. 3. Whether a transaction involving a newly developed or modified program is the service provision is based on all of the facts and circumstances, including who owns the rights to the new software and how the risks of loss are allocated between the parties. 4. The information provision regarding a computer program is considered as the know-how provision if the information relates to computer programming techniques, the information is furnished under conditions preventing unauthorized disclosure, specifically contracted for by the parties, and the information is considered property subject to trade secret protection.

42) See Treas. Reg. § 1.861-18(f)(1) (2016). See also Treas. Reg. § 1.861-18(h) Ex. 5 (stating that transfer of exclusive rights in one country is a sale).

III. Source of Royalties

The South Korea-U.S. tax treaty adopts the place of use rule as provided in Article 6(3) of the treaty to tax royalty income. The Korean domestic tax laws prescribe both the place of use rule and the place of payment rule and impose taxation on unregistered intangible property. This part reviews and analyzes the history of the source provision, the Korean Supreme Court decisions, and some related issues.

1. Overview of Provisions of Tax Treaty and Tax Law

1) Tax Treaty

Article 6(3) of the South Korea-U.S. tax treaty provides that royalties described Article 14(4) for the use of, or the right to use, property described in that paragraph is treated as income 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.

2) South Korean tax law

The South Korean tax laws⁴³⁾ provide that royalties are the South Korean-sourced income if (i) intangible property or rights described there are used in South Korea or (ii) consideration for the use of such property or rights is paid in South Korea. Such laws further provide that intangible property required to register for exercising such rights as patents, trademarks, or design is deemed as used in South Korea, even though it is registered overseas if it is used for manufacturing or selling in South Korea, which was added in the tax laws revised in 2008 and effective from income generated on or after January 1, 2009.

If it is interpreted literally, under the tax treaty, an undefined term like “use” has the meaning that it has under the laws of South Korea when it applies in South Korea. In this regard, the South Korean Supreme Court has recently held that the payment made as consideration for the use of a

43) CTA art. 93(8), ITA art. 119(10).

patent that was not registered in South Korea should not be treated as a South Korean source income, and maintains its prior position on the concept of the place of use taken under the law before its amendment in 2008.⁴⁴⁾

2. Legislative History and the Position of the Supreme Court on the Concept of the Term “Use” in South Korea

1) Prior Law and Its Interpretation by the Court

Under the laws before their amendment in 2008, the income derived from the use of intangible property as defined there (including patents) in South Korea or the income paid in South Korea was treated as South Korea source income. However, under Article 6(3) of the South Korea-U.S. tax treaty, royalties are treated as a South Korean source income only if paid for the use of, or the right to use, such property within South Korea. In this respect, as shown in the cases of 2005Du8641 and 91Nu6887 below, the Supreme Court of South Korea held that patents can be effective only in the jurisdiction in which such patents are registered in accordance with the territorial patent law. Consequently, the payment for the use of patents is treated as a South Korean source income only if such patents are registered in South Korea under the South Korean patent law. Therefore, according to the Supreme Court’s position, if a patent is registered outside of South Korea, the payments made in consideration for the use of such patent will not be considered a South Korean source income.

In its 91Nu 6887 (May 12, 1992) ruling, the Supreme Court of South Korea held that consideration received from the use of a patent not registered in South Korea is not a South Korean source royalty. A, an American corporation that had no permanent establishment in South Korea, had a patent for materials used in manufacturing automobiles. A registered the patent in the United States, but not in South Korea.

X, a Korean domestic corporation, manufactured automobiles in South Korea in which A’s patented materials were used, after which the automobiles were exported to the United States through A’s subsidiary B,

44) See *infra* part III.B.2.

an American corporation. B paid fees for A's patented materials, which X used in South Korea, and X reimbursed those fees to B. X did not withhold tax on such fees, but the tax officer sent X an assessment notice alleging that such fees were the South Korean source royalties.

The Supreme Court of South Korea held that the fees were not a Korean source income. The Court reasoned that, under the CTA, a patent is effective only in the country where the patent was registered and that payments made in consideration for the use or infringement in South Korea of the patent not registered in South Korea are not the South Korean-source royalties. The Court ruled that royalties received as consideration for the domestic use of a patent as provided in the CTA and royalties received as consideration for the use as provided in the South Korea-U.S. tax treaty should be interpreted as indicating royalties received as consideration for the use of the patent in South Korea that a foreign corporation has registered in South Korea according to the Korean domestic law.

In its 2005Du 8641 (Sept. 7, 2007) ruling, the Supreme Court of South Korea sustained its prior position. C, a Korean domestic corporation, had sold electronics manufactured in South Korea to American customers through its subsidiary D, an American corporation. E, an American corporation, took legal action against D, contending that D infringed E's patent right registered in the United States. Ultimately, D and E made a settlement and, according to the settlement agreement D paid the amount upon which they agreed (in substance the settlement money is comprised of the fees on which C used or infringed E's patent). C reimbursed D the amount that D paid to E. The tax officer sent an assessment notice alleging that the consideration paid to E was the South Korean-source royalties.

The South Korean Supreme Court held that consideration paid to E did not comprise the South Korean source royalties. The Court reasoned that, since the "territorial principle" applies to patents, the owner's exclusive right to the patents, such as manufacturing, licensing, transferring, renting, utilizing, and exhibiting, is effective only on the territory of the country in which the patent is registered.

2) *New Provision and the Supreme Court's Position*

After the decision in the 2005 Du 8641, the articles of tax law at issue⁴⁵⁾ were amended in 2008 by adding a new provision that prescribes that the intangible property required to register for exercising rights of such intangible property, such as patents, trademarks, or designs, is deemed as used in South Korea, even though it is registered overseas if it is used for manufacturing or selling in South Korea.

However, even under the revised laws, the Supreme Court did not change its prior position that the payments made in consideration for the use of a patent not registered in South Korea should not be treated as a South Korean source income under the South Korea-U.S. tax treaty as deliberated in the 2012Du18356 case below.

In the 2012Du18356 (Nov. 27, 2014) case decided by the Supreme Court,⁴⁶⁾ F, an American corporation, and its parent corporation, also an American corporation (collectively "F"), and G, a South Korean domestic corporation and its subsidiaries, American corporations (collectively GS), had argued for infringements of their respective patent rights and filed lawsuits against each other. Ultimately, F and GS reached a settlement agreement in which they terminated their lawsuits, allowed the use of their respective patents, and G paid to F certain amounts agreed upon as consideration for the use of F's patents. G withheld taxes on all such payments. However, some of the consideration was for the patents that had not been registered in South Korea. Later, F filed a refund claim against the tax office asserting that the payments made in consideration for the use of the patents unregistered in South Korea were not a Korean source income. The tax office denied this claim. The issue was whether the payments made in consideration for the use of the patents unregistered in South Korea were still the South Korean source royalties under the new provision.

The Court held that such payments were not the South Korean source income. The Court ruled that, when the patent right of an American corporation was registered overseas, but not in South Korea, and was used in manufacturing or selling goods, the issue whether the payments made

45) CTA art. 93(8), ITA art. 119(10).

46) See also Supreme Court, 2013Du9670, Dec. 11, 2014. (drawing the same conclusion as this case).

for that kind of use was within the South Korean source income should be resolved in accordance with the South Korea-U.S. tax treaty in compliance with Article 28 of the *gukjejosejojeonge gwanhan beomnyul* [International Tax Coordination Law; hereinafter ITCL],⁴⁷⁾ regardless of the provision of the amended CTA. The Court reaffirmed its prior position that in application of the provisions of Articles 6(3) and Article 14(4) of the tax treaty, “territorial principle” applies to patents, as the result of which the owner’s exclusive right to the patents, such as manufacturing, licensing, transferring, renting, utilizing, and exhibiting is effective only on the territory of the country in which the patent is registered.

The Court also ruled that Articles 6(3) and 14(4) provide only that, if an American corporation registers its patent in South Korea and has the right to the patent in South Korea, the payments made in consideration for the use of such patent are a South Korean source income. The Court further ruled that the notion of the “use” to unregistered patents or the payments made in consideration for such patents does not arise, as the infringement on a patent occurs only in the country in which a patent is registered.

Consequently, the Court held that the payments made by G to F, which were in consideration for the use of patents that had not been registered in South Korea, were not the South Korean source royalties.⁴⁸⁾

To sum up, from South Korea’s perspective, if a patent is registered only in the United States or elsewhere, but not in South Korea, consideration for the use of such a patent does not fall within the South Korean source royalties under the South Korea-U.S. tax treaty, even though domestic Korean tax law provides otherwise. This means that the provisions of the South Korea-U.S. tax treaty takes precedence over the domestic tax law of South Korea.⁴⁹⁾

47) Article 28 of ITCL provides that, notwithstanding Article 119 of the ITA and Article 93 of the CTA, the tax treaty shall be applied in priority to the characterization of the source of income of non-residents or foreign corporations.

48) The same court held that such payments are not consideration for know-how, since, once a patent was registered in the United States, it was no longer unpublished information.

49) See *infra* part III.D.

3. Compare with the Source Rule of the United States

In the United States, royalties from lessees of intangible property have their source where the property is located.⁵⁰⁾ The location of the property is generally equivalent to the place where the property is used.⁵¹⁾ Generally, the “place of use” is the place where the intangible property is legally protected.⁵²⁾ A right in intangible property has an effect and exists only in the country under the laws of which the right is issued.⁵³⁾

Therefore, the concept of the use of intangible property is identical in both South Korea and the United States; that is, intangible property can be used only in the protected jurisdiction. Accordingly, for instance, the payments made by a Korean domestic corporation or a resident of South Korea in consideration for the use in South Korea of patents registered in the United States, but not in South Korea, are not a Korean source income under the South Korea-U.S. tax treaty. Similarly, the payment made by an American corporation or resident in consideration for the use in the United States of a patent registered in the South Korea, but not in the United States, is not a U.S. source income under the South Korea-U.S. tax treaty.

3. Some Issues for Further Consideration

1) The Issue of Overriding Tax Treaty; South Korea versus the United States

Can statutes or case law abolish the existing tax treaty or reduce its application? The Constitution of South Korea provides that “treaties duly concluded and promulgated under the Constitution ... shall have the same effect as the domestic laws of the Republic of South Korea.”⁵⁴⁾ Under the South Korean legal system, there is no hierarchy between domestic law and

50) IRC §§ 861(a)(4) (2016), 862(a)(4) (2016).

51) See BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS*, ¶ 73.5.1 (2016); Orly Mazur, *Taxing the Cloud*, 103 Cal. L. Rev. 1, 27 (2015).

52) See Orly Mazur, *supra* note 51, at 27; RICHARD E. ANDERSEN, *ANALYSIS OF UNITED STATES INCOME TAX TREATIES* ¶ 11.01(2)(a)(i). See also *SDI Netherlands B.V. v. Comm’r*, 107 T.C. 161, 175-76 (1996); Rev. Rul. 68-443, 1968-2 C.B. 304.

53) See *AMP, Inc. v. United States*, 492 F. Supp. 27, 34-35 (MD Pa. 1979).

54) S. Korea Const. art. 6(1).

treaties, but a special law prevails over a general law. A tax treaty is a kind of special law in the South Korean legal system. Consequently, the provisions of a tax treaty generally prevail over those of domestic law. In addition, a special tax law provides that a provision of a tax treaty shall have priority over a provision of other tax laws.⁵⁵⁾ Therefore, from South Korea's perspective, the amended provision of the tax law cannot override a provision of a tax treaty ratified and effective before the amendment of the tax law.

By contrast, from the perspective of the American legal system, no priority in the application of a tax treaty exists between treaties and domestic laws. Between treaties and domestic laws, first enacted or amended apply first.⁵⁶⁾ Therefore, the American legal system permits a new amendment of the tax law to override a certain provision of a tax treaty.⁵⁷⁾ However, under the South Korean legal system, this is impossible.

2) *Issue of Effective Overriding in the Application of a Newly Added Provision of Article 93(8)*

In South Korea, it is an established rule that a newly revised provision of domestic law cannot override a provision of a tax treaty previously duly ratified and effective. Under this principle, most agree with the view that a newly added provision of Article of 93(8) of the CTA does not override the provision of the South Korea-U.S. tax treaty. Nevertheless, some commentators argue that such a newly added provision should apply to interpret the current South Korea-U.S. tax treaty through the application of Article 2(2) of the Treaty.⁵⁸⁾

Article 2(2) of the South Korea-U.S. tax treaty provides that an undefined term used in the treaty has the meaning which it has under the

55) See *supra* note 47.

56) See IRC §§894(a) (2016), 7852(d) (2016). See generally, BORIS I. BITTKER & LAWRENCE LOKKEN, *supra* note 51, 65.4; Richard L. Doernberg, *Overriding Tax Treaties: The U.S. Perspective*, 9 Emory Int'l L. Rev. 71 (1995).

57) See, e.g., IRC § 894(c) (2016).

58) See generally, Cheol-Hyung Yu, *Gungnae mideungnok teukeowa gungnaewoncheon-sodeugin sayongnyo- gwallyeon dae beobwon pangyeoreul jungsimeuro* [Patents Unregistered in Korea and Korean Source Royalty Income-Focus on Relevant Supreme Court Decisions-], 32 JOURNAL OF IFA KOREA, no. 4, 119-163 (2016).

laws of the Contracting State whose tax is being determined, unless required otherwise by the context. Thus, it seems that the question whether the use of the patent that is not registered in South Korea is in “use” in South Korea as provided in the tax treaty should be decided according to the Korean domestic tax laws, since the term “use” is not clearly defined in the tax treaty.

If the provision applies literally, the South Korean government can redefine an undefined treaty term by its domestic law, which, in turn, may effectively override a provision of a tax treaty such as Article 14(4). However, such effective overriding by domestic laws cannot be permitted; instead, the redefinition of the term used in the treaty should be allowed, only if the redefinition does not override the then-existing treaty.

Moreover, if a revised provision of the domestic tax law is intended to confine or evade the rule that the Supreme Court has established and if the application of the new provision to interpret the meaning of the term in the tax treaty consequently increases tax liability under the tax treaty, contrary to the prior interpretation under the rule set by the Supreme Court, the revised provision should not apply to the tax treaty, as such an application would effectively override the tax treaty duly ratified and already effective.

In this respect, the decision in 2012Du18356 is acceptable and desirable, since, if the amended provision of the CTA applies to the interpretation of the South Korea-U.S. tax treaty, it will effectively override the treaty provision by changing the term’s meaning already established by the decision of the Supreme Court. To change the meaning of such a term, the provision at issue should be revised by bilateral renegotiation.

In a negative aspect, the position of the South Korean Supreme Court makes it possible for the parties in intangible transactions to arrange to escape the South Korean source rule by intentionally evading registering the rights in the intangible property in South Korea.

V. Conclusion

To decide the source of royalties, whether a certain income is royalty income should first be determined. Consequently, this article first reviewed the royalty provisions of the tax laws and the South Korea-U.S. tax treaty

and the issue of characterization.

Regarding whether or not the payments made in consideration for the use of intangible property are royalties or service income, there is no clear guidance in South Korea other than technical service fees. Therefore, the American case law related to the creation of intangible property was reviewed to get some guidance to resolve similar issues in South Korea. South Korean tax authorities take the position that a single lump sum payment in full at the sale of intangible property is a royalty, if the payment is calculated based on future cash flow from the property sold. However, this position should be changed, since it has no reasonable basis.

South Korea has no statute or case law regarding whether or not a transfer of intangible property is a sale or a license. In this respect, the interpretation in American courts may be acceptable.

Regarding the issue of the transfer of a computer program, the provisions of the U.S. Treasury Regulation may be helpful to resolve similar issues that might arise in the application of the South Korea-U.S. tax treaty, since the provisions of the regulation are more comprehensive and detailed than those of South Korea. However, consideration paid for the transfer of the ownership of the rights in the copyright underlying the software is a royalty in South Korea.

The South Korea-U.S. tax treaty has adopted the place of use rule as the source rule for royalties. However, the term “use” in the treaty is not clearly defined yet. Moreover, the South Korean domestic tax law has a provision that conflicts with the tax treaty. Specifically, an issue has arisen whether a patent unregistered in South Korea can be said to be in “use” in South Korea. In this regard, this article reviewed legislative history and the position of the South Korean Supreme Court.

Even under the revised tax laws, the Supreme Court held that the payment made as consideration for the use of a patent that was not registered in South Korea should not be treated as South Korea source income, thereby maintaining its previous position of “territorial principle.” Therefore, if a patent is registered only in the United States or elsewhere, not in South Korea, consideration for the use of such a patent in South Korea does not fall within the South Korean source royalties under the South Korea-U.S. tax treaty. South Korea’s position on the “use” of intangible property is identical to the American position, which is that the

“place of use” is the place in which the intangible property is legally protected.

As related issues, in the American legal system, a new amendment in tax law may override a provision of a tax treaty. By contrast, under the South Korean legal system, such an override is impossible. If the established rule in South Korea strictly applies, the effective overriding of a tax treaty should not be allowable through a new interpretation of a term of the tax treaty. In this regard, the decision of the South Korean Supreme Court to apply the tax treaty following the addition of the new provision at issue is acceptable and desirable.