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Philippines

Introduction

The Philippines' statutory transfer pricing rule is patterned after what is now Section 482 of the US Tax Code. It was codified in 1939 and has remained unchanged since. Court decisions have also confirmed that Section 482 of the US transfer pricing regulations can be used as guidance when applying the Philippine transfer pricing rules. The Philippine Bureau of Internal Revenue (BIR) also relies heavily on the Organisation for Economic Co-operation and Development (OECD) Guidelines.

Since 2005, the BIR has begun challenging the transfer pricing arrangements of some taxpayers. These challenges arise mostly from ad hoc examinations during a regular tax audit. BIR auditors are gaining sophistication in this area; they have made significant transfer pricing tax assessments, although these could also be based on a misappreciation of issues. Because of this and the potential issuance of more comprehensive transfer pricing revenue regulations, companies are advised to pay close attention to transfer pricing arrangements when doing business in the Philippines.

Statutory rules

The statutory rule on transfer pricing is found in Section 50 of the National Internal Revenue Code (NIRC). The rule has remained essentially unchanged since 1939, when it was patterned after the transfer pricing rule in the US Revenue Act of 1934. Section 50 allows the BIR to allocate income and deductions between related parties as a means to prevent tax evasion or clearly reflect the amount of income earned by each party.

Other regulations

The only formal regulations for transfer pricing are found in Section 179 of Revenue Regulations No. 2, issued in 1940. These regulations were drawn directly from Article 45 of US Regulation 86, issued in 1935, and details the scope and purpose of the transfer pricing rule – to place a controlled taxpayer on tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer.

Additional guidance is provided in Revenue Audit Memorandum Order (RAMO) No. 1-98 and Revenue Memorandum Order (RMO) No. 63-99. The former, issued in 1998, provides audit guidelines and procedures for examining interrelated groups of companies and endorses the use of the OECD Guidelines. The latter, issued in 1999, deals with intragroup loans and broadly follows US Section 482 regulations. Both documents are less authoritative than regulations, but they reinforce the general theme that Philippine transfer pricing rules should be applied in accordance with the arm's-length principle as it is applied internationally.

The government plans to issue more detailed transfer pricing regulations, a final draft of which has been in existence since 2006. Due to changes in the BIR leadership, however, these new regulations have yet to get the final approval of the Secretary of Finance to become effective. In the meantime, the BIR has stated through Revenue Memorandum Circular (RMC) No. 26-08, issued in 2008, that it will follow the OECD Guidelines in resolving transfer pricing issues and concerns.

Legal cases

The broad doctrine followed in the Philippines is that when Philippine law is based on an equivalent provision in the US Tax Code, the decisions of American courts interpreting said US provision are entitled to significant weight in applying such Philippine tax laws.

In two Philippine cases relating to transfer pricing, the Court of Tax Appeals (CTA) has taken the doctrine further and allowed the Section 482 regulations to have persuasive effect.

In the Cyanamid case (1995, affirmed by the Court of Appeals [CA] in 1999), the CTA held that the BIR had acted in an arbitrary, unreasonable, and capricious manner when it made no apparent attempt to verify the comparability of pharmaceutical products being compared under a comparable uncontrolled price (CUP) method analysis.

In the Filinvest case (2002), the CTA upheld the imputation of interest by the BIR on an interest free loan. The CTA also required the BIR to allow correlative relief by way of an interest deduction, based on Section 1.482-(1)(g) of the US regulations. Upon appeal, however, the CA reversed this decision, citing that the imputation of interest rule does not apply to alleged indebtedness which is in fact a contribution of capital; the CA appreciated the loan/advances made in the case to be capital contributions. In 2011, the Supreme Court (SC) affirmed the decision of the CA. The SC ruled that the BIR's power to allocate gross income does not include the power to impute 'theoretical interest' because there must be actual or, at the very least, probable receipt or realisation by the taxpayer of the income that is being allocated. In this case, both the CA and the SC also recognised that under Philippine law, interest cannot be imposed unless expressly stipulated in writing.

The same issue on imputation of interest was presented in the Belle Corporation case (2005) where the CTA ruled in favour of the taxpayer, deciding that RMO 63-99 was inapplicable to the facts of the case.

Two other cases decided by the CTA in early 2005, Avon Products and ING Barings Securities, validated the notion that the initial burden to prove that the inter-company pricing complies with the arm's-length principle lies with the taxpayer. However, once proof is provided, the onus shifts, and the revenue authority is supposed to prove that its basis for questioning the taxpayer's policy has sufficient support. Accordingly, in these two cases, the courts ruled in favour of the taxpayers after the BIR failed to produce evidence to refute oral explanations by the taxpayers during the trial proceedings.

Anticipated developments

The BIR has drafted comprehensive Transfer Pricing Revenue Regulations (TPRR) that seeks to consolidate and expand the existing transfer pricing issuances. The provisions in the draft TPRR were heavily lifted from the US TP regulations and OECD Guidelines.

The draft TPRR includes a reiteration of the BIR Commissioner's authority to look at transfer pricing, as well as the bureau's adoption of the arm's-length standard in determining the true taxable income of a controlled taxpayer.

The draft regulations also provide for five methodologies in determining the arm's-length price. The five methods are all accepted internationally. In broad terms, these methods can be grouped into two categories: the traditional transaction method consisting of (1) the comparable uncontrolled price (CUP) method, (2) the resale price method, and (3) the cost plus method; and the transactional profit methods involving (4) the profit split method and (5) the transactional net margin method.

The application of each method depends on the transaction and the circumstances involved; the draft TPRR contains illustrations to show the interplay of the different methods. No hierarchy of methods is provided in the draft regulations, but they do indicate that the method requiring the fewest adjustments and providing the most reliable measure of the arm's-length result is the preferred method.

The regulations also provide more details on the general rules that apply to specific situations, such as loans or advances, performance of service for another, use and sale of tangible property, and transfer or use of intangible property. In all these cases, the concept of comparability, determination of the appropriate transfer pricing method, and the arm's-length principle apply.

The draft regulations provide guidelines for the preparation of documentation to support the transfer price adopted. The BIR requires fairly extensive documentation, including functional and economic analyses of the taxpayer's business and results, as well as benchmarking. Based on the draft TPRR, when the BIR requests transfer pricing documents, the taxpayer must submit them within 45 days of the request.

Although the TPRR still needs to be signed by the Secretary of Finance to become effective, the BIR has already started challenging taxpayers using the provisions of the TPRR. Assessments made to date run into hundreds of millions of pesos, and there is reason to believe that this BIR challenge will continue.

In 2009 and 2010, the BIR specifically mandated the audit and investigation of certain taxpayers, including companies that are interrelated or that form part of a conglomerate. Through the issuance of RMO No. 23-2009 and RMC No. 36-2010, special audit teams under the Large Taxpayers Services and Enforcement Division of the BIR were created and assigned to conduct a simultaneous, joint and coordinated audit and examination of the books of accounts of the identified taxpayers to ensure that these taxpayers are clearly reflecting income and expenses attributable to inter-company transactions.

There are indications that the BIR is conducting structured training for its personnel. In fact, following the release of the Revised OECD Guidelines last July 2011, OECD Transfer Pricing Advisors conducted a briefing for BIR officials on the revised

Guidelines and recent international developments in transfer pricing. In view of these developments, taxpayers can expect the BIR to be more knowledgeable on, and to pay greater attention to, transfer pricing in the Philippines.

Burden of proof

As a general rule, taxpayers should be prepared to justify their transactions to the BIR. The NIRC affords the BIR commissioner fairly strong assessment and collection powers. However, the burden of proof shifts to the BIR once the taxpayer is able to demonstrate that its pricing complies with the arm's-length principle, as the 2005 cases of Avon Products and ING Barings Securities demonstrate.

Tax audit procedures

To date, transfer pricing has been raised as an issue only in the context of regular audits by the BIR. A framework does exist, however, for issue-oriented audits to be undertaken.

Based on the fact that the BIR is training its people and the likelihood that regulations will be issued, it seems reasonable to expect transfer pricing-specific audits to occur in the future.

The audit procedures

The tax examination process starts with the issuance of a Letter of Authority by the BIR. This authorises a specific revenue examiner to gather documents and financial information from the taxpayer, such as books of accounts and other accounting records, for the purpose of determining whether the taxpayer has deficiency tax liabilities.

Upon discovery of deficiency tax, the revenue examiner is required to prepare a report stating whether the taxpayer agrees with the findings. If the taxpayer does not agree with the examiner's findings, the BIR communicates the examiner's findings to the taxpayer in writing and offers the taxpayer the opportunity to respond in an informal conference.

If the taxpayer fails to respond within 15 days from receiving the notice from the BIR, or engages in the informal conference but is unable to dissuade the revenue examiner from the examination findings, the case is referred to the Assessment Division of the Revenue Regional Office (ADRRO) or to the commissioner or the duly authorised representative for appropriate review and issuance of a deficiency assessment, if warranted. If the ADRRO determines that sufficient basis exists to assess the taxpayer for deficiency tax, it issues a Preliminary Assessment Notice (PAN) which the taxpayer must contest within 15 days from receipt. If the taxpayer does not contest the PAN, a formal letter of demand and assessment notice is issued.

Appeals procedures

Within 30 days from receipt of a formal demand and assessment notice, a taxpayer must file an administrative protest with the BIR. The taxpayer then has 60 days from date of filing of the protest letter to submit all the required documents supporting the protest. Failure to meet these requirements renders the assessment final, executory, and demandable.

If the protest is denied by the BIR, the taxpayer has 30 days from receiving advice from the BIR to appeal the decision to the CTA. Alternatively, if the BIR fails to act on the taxpayer's protest within 180 days from submission of the documents supporting its protest, the taxpayer has the right to appeal to the CTA within 30 days from the end of that 180-day period to expedite resolution of the protest.

An adverse decision by a CTA division may be appealed to the CTA en banc, and from there, to the Supreme Court.

Additional tax and penalties

The Philippines does not have specific transfer pricing penalties, hence transfer pricing adjustments are governed under the general penalty rules. A 25% surtax is generally imposed on tax deficiencies. Interest is imposed on the deficiency tax (but not on the surtax) at 20% per annum. A compromise penalty of up to 50,000 Philippine pesos (PHP) is also imposed.

Resources available to the tax authorities

The BIR's computerisation programme is now producing positive results in terms of catching tax evaders. The efficiency of its system has, to date, generated a significant amount of tax collections, and there are indications that the BIR will leverage the system for its other revenue-generating efforts. However, whether it will be used as an aid to challenge taxpayers' transfer pricing policies and arrangements remains to be seen.

In addition, the BIR has issued RMO No. 05-12, prescribing updated guidelines in taxpayer profiling and benchmarking activities to help address collection problems, plug tax leakages and implement risk-to-revenue based audit and enforcement activities. Under this issuance, the agency shall adopt the Performance Benchmarking Method as a surgical measure to detect tax leakages and improve collections on value-added tax, income tax and other taxes. The benchmarking results could potentially be used by the BIR as basis to conduct transfer pricing-specific audits.

Risk transactions

The BIR has increased its challenges on the transfer pricing arrangements of multinationals, and the areas of concern are varied. For example, whereas previously the BIR would be content with brief explanations on payments for management services, they now require further proof on the validity of these charges, sometimes asking for additional documentation such as passport details of visiting foreign employees and basis of the charges.

The provision of outbound services is now also attracting the BIR's attention. Previously, a 5%–10% mark-up on cost could be safe harbour. However, it is difficult nowadays to say that even a 10% mark-up is defensible, especially if the services involve high-value-adding activities such as R&D, technical design, or knowledge processing outsourcing services. Benchmarking therefore is key. What apparently alerts the BIR is when they notice a sharp decline in profitability in certain companies' operations once they finish their tax holiday, which is generally available for these sunshine industries. Certainly, this is an area that the BIR will be looking into more closely in the future.

Thin capitalisation

The Philippines does not have statutory rules dealing with thin capitalisation, although this does not prevent the tax authorities from attempting to recharacterise interest as dividends. The TPRR also contains provisions on thin capitalisation, indicating that an interest payment or accrued interest attributable to the excess debt shall be treated as dividends, hence shall be taxed accordingly and shall not be deductible.

The proposed rules in the TPRR provide for a threshold ratio of three-to-one (3:1), unless a different debt-to-equity ratio is prescribed by special laws or special provisions of existing law. This 3:1 ratio does not apply to banks, financing companies and non-bank financial intermediary performing quasi-banking functions.

Advance pricing agreements (APAs)

The TPRR recognises that an APA could be useful in avoiding or resolving transfer pricing disputes. APAs look to the future, in that the agreement involves setting an appropriate set of criteria (e.g. methods, comparables and adjustments, and critical assumptions) for the determination of the transfer pricing for the covered transactions over a fixed period of time. The result is a stable transfer pricing environment for the parties involved, so much so that a taxpayer can rest assured that its transfer pricing arrangements will not be challenged by the BIR as long as it complies with the parameters set.

APAs may also involve the agreement of more than one revenue authority and taxpayer. The draft regulations provide details on how APAs may be initiated, monitored and concluded.

Joint investigations

No public evidence suggests that the BIR has been or is prepared to be involved in joint investigations with the authorities of other jurisdictions, although a framework exists under existing BIR issuances.

OECD issues

The Philippines is not a member of the OECD. However, the BIR relies heavily on the OECD Guidelines and treaty models with regard to international tax issues. As earlier mentioned, in RMC 26-2008, the BIR stated that, as a matter of policy, it subscribes to the OECD Guidelines. Taxpayers, therefore, should feel confident that they will be in better standing if they follow the OECD Guidelines.