Tax Bulletin

Special Issue on the Transfer Pricing Audit Guidelines

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Highlights

RAMO No. 1-2019, known as the "Transfer Pricing Audit Guidelines," prescribes the standardized audit procedures and techniques in conducting the audit of taxpayers with related party and/or intra-firm transactions.

Revenue Audit Memorandum Order No. 1-2019 issued on 27 August 2019

I. Coverage

- The RAMO applies to the examination of the following transactions:

  1. Controlled transactions between related/associated parties where at least one party is assessable or chargeable for tax in the Philippines on the following transactions, among others:

     - Sale, purchase, transfer and utilization of tangible and intangible assets;
     - Provision of intra-group services;
     - Interest payments; and
     - Capitalization

  2. Transactions between permanent establishment (PE) and its head office or other related branches.

  3. The RAMO will also apply to intra-firm transactions, which occur when a taxpayer engaged in activities subject to different tax regimes [income tax holiday (ITH), 5% gross income tax (GIT) and regular corporate tax] misallocates profits and costs in order to minimize tax liabilities.

II. Audit Procedure

- There are 3 stages to a transfer pricing (TP) audit: preparation, implementation and reporting:

  1. Preparation

     - The audit preparation stage involves determining the scope of the audit, gathering of information on the related party transactions, conduct of meetings with taxpayers to discuss the initial findings, and risk analysis of an arm's length price (ALP).
     - In assessing the risk of an ALP, the following factors, among others, shall be considered:

       a. Worldwide effective tax rate and whether the overall tax position is such that income shifting is beneficial from a financial accounting/cash flow standpoint;

       b. Materiality of related party transactions;

       c. Taxpayer's transactions with related parties located in countries or economic zones with low or zero tax rates;

       d. Related party transactions of a special nature, such as transfer of intangibles, assets (license), royalty payment, intra-group services and interest expense;

e. Performance of taxpayer's net operating profit is lower than that of other companies in the same industry; and

f. The taxpayer suffered losses over several years.

- During this stage, the Bereau of Internal Revenue (BIR) may request for the submission of documents in a format prescribed under the RAMO on the following within 5 days from receipt of the notice:

  a. Related Party Transactions;

  b. Segmented Financial Statements;

  c. Supply Chain Management Analysis;

  d. Function, Assets and Risks Analysis (FAR Analysis);

  e. Characteristics of Business; and

  f. Comparability Analysis

2. Implementation

- During the implementation stage, the BIR will determine the characteristics of the taxpayer's business, perform a FAR analysis on the taxpayer, select the TP method, the tested party and apply the ALP.

- In performing a FAR analysis, the revenue officers (RO) will obtain and review several sources of information, such as:

  a. Organizational chart of the taxpayer and structural chart of the group;

  b. List of all employees, job descriptions and the authorities of the employees involved in the economically relevant functions;

  c. Audited financial statements;

  d. Segmented financial statements by function and independence of transactions;

  e. Global pricing policy document;

  f. Licensing contracts for intangible assets; and

  g. TP documentation.

- The ROs will also identify and confirm the type of assets used by the taxpayer, including the existence of intangible assets, such as those relating to manufacturing and marketing, and the taxpayer's contribution to the creation, development, protection and maintenance of the intangible assets.

- The ROs may disregard and re-characterize a controlled transaction in cases where the economic substance differs from its form or where the form and the substance of a transaction are the same, but the arrangements are not commercially rational and prevent the ROs from determining an ALP.

3. Reporting

    - At the reporting stage, the ROs shall prepare a report, which shall include, among others, the factual background and functional analysis of the taxpayer and the transaction(s) at issue, a summary of the taxpayer's proposed economic analysis, evaluation of the taxpayer's methodology, as well as a determination of an ALP based upon the economic analysis.

III. **TP Audit Method**

- The TP audit on a taxpayer's transaction with its related/associated parties can be conducted by performing test of prices or profits.
- The test of application of the ALP is performed by applying the TPM which is the most appropriate to the facts and conditions.
- The TP Methods identified in the RAMO are the following:

    1. Comparable Uncontrolled Price (CUP) Method
    2. Resale Price Method (RPM)
    3. Cost Plus Method (CPM)
    4. Transactional Net Margin Method (TNMM)
    5. Profit Split Method
        - Contribution Profit Split Method
        - Residual Profit Split Method

IV. **Business Restructuring**

- Business restructuring within a multinational group often occurs when there is a change of business characterization and a reduction of profitability of a local entity.
- Such reduction of profits is acceptable only with reduced functions performed, assets employed, and risk assumed.
- If the local entity continues to perform the same functions and bears the same risks, the RO will make the necessary adjustments.

V. **Intra-Group Services**

- Intra-group services are activities provided by one party within a business group that provide benefits for one or more members in the business group.
- The existence of transactions for the delivery of intra-group services is recognized if the service provides economic benefit or commercial value that improves the commercial position of the company receiving the services.

- The following are the steps in applying the arm's length principle to intra-group services:

    1. Determine if a service from a related party has, in fact, been performed and provided economic benefit to the other related party.

    2. Calculate the ALP for the service.

- Shareholder activities, duplicative services, those that provide incidental benefit and on-call services are not considered intra-group services.

VI. **Intangible Asset Transactions**

- Intangible assets are those that are neither physical nor financial assets, and can be classified into manufacturing and marketing intangibles.

- In testing intangible asset transactions, the existence of an intangible asset that contributes to the success of the product in the market will be determined.

- The value of the intangible assets and the parties who contributed to the formation of the intangible assets will be identified.

- The ROs will also determine whether there has been a transfer of intangible assets and in such a case, the arm's length compensation for the transfer.

VII. **Cost Contribution Arrangements (CCA)**

- The CCA is a framework in the form of a contractual agreement among companies to share the costs and risks of developing, producing, or obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. Where a taxpayer enters into a CCA with its associated parties, the arrangement should reflect that of an arm's length arrangement.

VIII. **Interest Payment Transactions**

- Audits of intra-group loan transactions are conducted to test the arm's length nature of the taxpayer's debt-to-equity ratio and to test the reasonableness of the interest rate and/or expenses related to the intra-group loan transaction that are charged to the taxpayer.

- The debt-to-equity ratio of a taxpayer engaged in related party transaction is arm's length if it is comparable to the debt-to-equity ratio of comparable companies.

- The testing of the interest rate of loans is done by comparing the rate of the RP loan with that commonly used by independent parties, such as Bangko Sentral ng Pilipinas (BSP), London Interbank Offered Rate (LIBOR), Singapore Interbank Offered Rate (SIBOR), USOR, or JISOR, plus a certain amount based on the credit rating of the party receiving the loan.

IX. **Effectivity**

- All ROs are directed to use the audit guidelines in the audit/investigation of tax returns immediately after the approval of this RAMO.

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