Philippines issues transfer pricing audit guidelines

In August 2019, the Philippines' tax authority, the Bureau of Internal Revenue (BIR), issued the country's first transfer pricing (TP) audit guidelines through Revenue Audit Memorandum Order (RAMO) No. 1-2019. It was intended to supplement Revenue Audit Memorandum Order (RAMO) No. 1-2000 (Updated Handbook on Audit Procedures and Techniques Volume 1) and RAMO No. 1-2008 (Computer-Assisted Tools and Techniques), and to provide standardized audit procedures and techniques in the conduct of audit of taxpayers with related party and/or intra-firm transactions to ensure quality audit.

Although the RAMO is primarily a manual for BIR officers, taxpayers can seek guidance from it, particularly, on how to proactively prepare for a TP audit in order to avoid or minimize TP adjustments and/or risks.

What is the scope of the TP audit guidelines?

The TP audit guidelines apply to controlled transactions between related parties/associated enterprises, where at least one party is assessable or taxable in the Philippines. These include, among others, the sale, purchase, transfer and utilization of tangible and intangible assets, provision of intra-group services, interest payments, and capitalization. The guidelines also apply to transactions between permanent establishment (PE) and its head office or other branches. Accordingly, the PE will be treated as a separate and distinct enterprise from its head office or other related branches/subsidiaries for tax purposes.

How will the TP audit be conducted?

The TP audit guidelines outline the following three (3) phases of a TP audit:

1. Preparation for TP audit

   This refers to the examination process which determines the scope and eventually, the focus of the audit. During this stage, the BIR will review available information and/or documents pertinent to the related party transactions of the taxpayer and set initial meeting/s with the taxpayer to discuss the taxpayer's business operations, key functions, product/service flow, TP policy, TP documentation, among others. At this stage, the BIR may request for information/evidence of related party transactions using the various templates of notices and documents attached to RAMO 1-2019.

2. Implementation of the TP audit

   This stage focuses on developing the issues and involves the technical application of transfer pricing rules. Here the BIR, while maintaining communication and interaction with the taxpayer, determines the characteristics of the taxpayer's business, selects the transfer pricing method and applies the arm's length principle. Note that the TP audit guidelines specifically mention that the BIR, in determining an arm's length price, may disregard and re-characterize intercompany transactions where the economic substance differs from the form, or there is no commercial reality.

3. Reporting of audit on TP

   As in a regular audit, the BIR officers will prepare a report on their TP audit which should include the following:

a. Executive summary;
b. Factual background and functional analysis of the taxpayer and the related party transaction/s at issue;
c. Summary of taxpayer's proposed economic analysis for the related party transaction/s at issue;
d. Critique of taxpayer's methodology and analysis of the related party transaction/s at issue;
e. Revenue Officer's determination of arm's length price based on economic analysis; and
f. Summary and conclusion.

The revenue officers shall meet with the taxpayer to discuss the audit findings on all issues prior to finalizing the report.

What will be required from the taxpayer in a TP audit?

The annexes to RAMO No. 1-2019 enumerate the information/documents that will be requested from taxpayers in a TP audit. They include the following, among others:

1. Information about related party transactions;
2. Segmented financial statements;
3. Supply chain management analysis;
4. Functions, assets, and risks (FAR) analysis;
5. Characteristics of the business;
6. Comparability analysis;
7. Transfer pricing method used;
8. Comparables used in applying the arm's length principle; and
9. Determination of the fair prices/profits in the related party transactions.

It should be noted that the template of the First Notice To Give Information on Related Party Transactions attached to RAMO 1-2019 prescribes a 5-working day period for taxpayers to submit the requested information which is a short timeframe especially for taxpayers who have yet to put together a TP documentation or supporting documents for their related party transactions.

CONCLUSION

The issuance of RAMO No. 1-2019 or the Philippine TP audit guidelines generally signals a positive development for transfer pricing enforcement in the Philippines. The level of details in the guidelines - as far as information expected from the taxpayer and audit procedures are concerned - provides both the taxpayers and tax authorities a clearer look at how transfer pricing audits will proceed in the Philippines in the near future. The guidelines give taxpayers a chance to improve or amend, where necessary, their current transfer pricing documentation to meet specific requirements under RAMO No. 1-2019 and accordingly, prepare for potential TP audits. This development also means that the BIR finally wants to get serious about transfer pricing enforcement in the Philippines and thus, should serve as an urgent "wake-up" call for Philippine taxpayers that have yet to prepare the necessary transfer pricing documentation that will serve as their first line of defense in a TP audit.

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