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OECD BEPS INCLUSIVE FRAMEWORK AND TRANSFER PRICING

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The Philippines' membership in the BEPS Inclusive Framework and what it means for Transfer Pricing audits

The Philippines is not a member of the Organisation for Economic Cooperation and Development (**OECD**), but their transfer pricing regulations are largely based on OECD Guidelines, which are referred to for further guidance and examples. On 11 October 2023, the Philippines joined the OECD Inclusive Framework on Base Erosion and Profit Shifting (**BEPS**), an international collaboration with over 140 member countries and jurisdictions. Through its membership, the Philippines has committed to align with the OECD BEPS programs to address tax challenges arising from digitalisation of the economy through reform of the international tax rules - to ensure that multinational enterprises (**MNEs**) pay their fair share of tax, wherever they operate.

This follows the January 2023 announcement by the Bureau of Internal Revenue (**BIR**), that they plan to establish a specific audit group with a focus on Transfer Pricing (**TP**), international tax and BEPS issues – and in doing so, capture the significant revenues from international transactions, that the BIR were missing out on. With the increased scrutiny on cross-border transactions in the Philippines, it is now more important than ever, for taxpayers to ensure that are prepared in the event of a TP audit.

The Philippine TP Audit Guidelines

The BIR laid the groundwork to strengthen its transfer pricing initiatives through the issuance of the Revenue Audit Memorandum Order ("RAMO") No. 1-2019 (Philippine Transfer Pricing Audit Guidelines) in August 2019, and RR No. 19-2020 on 8 July 2020, which required qualified entities to submit BIR Form No. 1709 (the Information Return on Related Party Transactions ("RPT") Form).

Under RAMO No 1-2019, BIR examiners are required to determine the arm's length price for each controlled transaction between related parties, based on the application of transfer pricing methods as prescribed in the OECD transfer pricing guidelines ("TPG").

The BIR Form No. 1709 is submitted with the annual income tax return, and it provides the BIR with the preliminary information that they need to conduct initial assessments, identify high-risk taxpayers, and decide on whether to conduct a transfer pricing audit. However, it is important to note that transfer pricing audits are carried out as part of regular tax audits, and they may be initiated as long as there are RPTs, regardless of the taxpayer's obligation to file the BIR Form 1709 or prepare transfer pricing documentation.

Transfer Pricing Audits in the Philippines

In the Philippines, all audits start with the issuance of a Letter of Authority ("LOA") for audits of all internal revenue taxes, including transfer pricing. When a taxpayer receives an LOA, transfer pricing documentation must be submitted. However, preparation of transfer pricing documentation is not mandatory where taxpayers do not meet the relevant thresholds. Nonetheless, taxpayers are required and expected to defend their respective transfer pricing practices regardless of whether they are required to prepare transfer pricing documentation or not.

When subject to an audit, taxpayers have up to five (5) days to provide sufficient proof that RPTs are conducted at arm's length and that they were not undertaken for tax evasion purposes. Failure to provide the required proof will result in adjustments to income or expenses, and additional tax liabilities and penalties.

Being prepared for a transfer pricing audit is crucial and audit readiness is best achieved through: (i) proper application of the arm's length principle, (ii) executing intercompany agreements between Related Parties ("RPs") that outline transaction terms and remuneration, and (iii) preparing adequate transfer pricing documentation to evidence the arm's length nature of RPTs.

Proper application of the arm's length principle requires analysing the RPTs to properly delineate the transactions and determine the transfer pricing policy (tested parties, appropriate transfer pricing methods and the arm's length prices) prior to entering into the RPTs. If these cannot be made before entering into the RPTs, testing the compliance to the arm's length principle afterwards is a possible alternative.

During an audit, the burden of proof to demonstrate compliance with the arm's length principle, tax legislation and obligations, resides with the taxpayer. Therefore, maintaining adequate arm's length documentation goes beyond just the preparation of the RPT Form and transfer pricing documentation (as applicable), to also include certified copies of relevant contracts, Advanced Pricing Agreements, withholding tax returns, proof of payment of foreign taxes, audited financial statements, and other documents as deemed necessary.

If an audit leads to an adjustment, there are no specific penalties in Philippine legislation, in relation to adjustments to related party transactions that do not comply with the arm's length price. Therefore, transfer pricing adjustments, if any, are subject to the imposition of general deficiency taxes, interests, and other penalties, as applicable.

Our Observation on Audits in the Philippines

The following are our observations regarding audits in the Philippines:

- Based on current regulations, transfer pricing examinations may be undertaken together with regular tax audits. However, there is no requirement that transfer pricing examinations be actually undertaken with regular tax audits. As such, revenue officers may issue tax assessments with no reference as to any potential transfer pricing issue. Notwithstanding this, taxpayers are still required to submit transfer pricing documentation with supporting documents within a certain period of time from receipt of the LOA.

- Due to the steady turnover rate of revenue officials, including those previously trained in conducting transfer pricing examinations, the BIR has continued to develop its officers' capabilities to perform transfer pricing examinations. It should be noted that in January 2023, the BIR Commissioner met with the Japan International Cooperation Agency to discuss a plan to create a transfer pricing team within the BIR. However, there has yet to be any significant outcome or impact observed in general practice.

- It is still unclear whether or not the BIR will make use of any third-party database to aid in verifying the transfer pricing analysis of the taxpayer or to arrive at its own transfer pricing assumptions. The current BIR databases may not be equipped to provide the necessary information for transfer pricing analysis.

- The BIR prefers local comparables over regional/international comparables. However, it should be noted that use of local comparables may be limited by the lack of financial information available in third-party databases to be used in the financial/economic analysis. Alternative methods (i.e. requesting financial statements from relevant government agencies) are necessary to secure the financial information of local comparables.

- The current transfer pricing examinations by revenue officials seem to be focused on certain taxpayers: (1) financial institutions, (2) large conglomerates and (3) major MNEs.

- Common related party transactions involving local entities that may be assessed by the BIR include, but are not limited to, the following:
  - Provision for administrative and other support (back-end) services;
  - Outsourced services;
  - Shared services and intra-group services;
  - Sale and distribution of goods;
  - Manufacturing of goods (both full-fledged and toll);
  - Royalties and transactions involving intangible assets;
  - Lease of real properties; and
  - Interest on intercompany advances/loans.

- The Philippines has a significant number a service-oriented entities, although these entities provide services to a different extent. Some entities may provide specialised services, while others may offer a wider range of services. Considering these differences, undertaking an accurate Functions, Assets and Risk analysis is crucial to determine potential comparables.

- Additionally, certain factors such as: (1) transactions with counterparties in countries with low or zero tax rates, (2) companies with lower net operating profit as compared with peer companies in the same industry, and (3) companies with year-on-year losses, may trigger transfer pricing audits.

Impact of BEPS Inclusive Framework Membership

In joining the Inclusive Framework, a likely outcome is that transfer pricing issues may increasingly become a regular finding during tax audits, resulting in increased revenues for the BIR and hopefully more robust transfer pricing practices that can withstand the scrutiny of an audit, for taxpayers.

The tacit recognition of the OECD TPG in the Philippine Transfer Pricing Guidelines is a clear indication that the Philippines intends to adopt internationally accepted tax principles. After several years of little to no activity, the membership of the Philippines in the BEPS Inclusive Framework highlights the renewed commitment of the Philippines to adopt international tax standards and to join the global effort to create a fair tax system which crosses boundaries and jurisdictions.

At the same time, the BIR is ramping up its capabilities and is exerting substantial effort in modernising and digitalising its services. This transformation is expected to apply not only to the tax administration, but also in the adoption of international tax principles, such as transfer pricing.

While not yet reaching mainstream tax consciousness, transfer pricing issues are slowly arising in assessments of multinational entities and large conglomerates, which is in tandem with the slow build-up of the BIR's ability to conduct transfer pricing audits. The BEPS Inclusive Framework membership would only work to highlight and provide emphasis on transfer pricing. As compared with the broader concept of the Two-Pillar solution, transfer pricing is significantly more advanced in the Philippines in terms of familiarity and administrative steps at implementation.

Concluding Thoughts

With the Philippines joining the Inclusive Framework on BEPS and assuming the Chairmanship of the Intergovernmental Group of Twenty-Four (G24) this year, it is inevitable that transfer pricing audits are going to be carried out on a much more regular basis. The BIR's creation of the specific audit group focusing on Transfer Pricing and BEPS issues clearly indicates that this will be the new status quo. Therefore, taxpayers need to have in place good transfer pricing policies and documentation that will withstand the scrutiny of a transfer pricing audit.

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