

Focus

For executives of multinational corporations

Punongbayan & Araullo 

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Taxation

Philippine tax court rules on arm's length pricing

When is the export price of goods sold or a fee commission from a related-party transaction considered arm's length?

In Court of Tax Appeals (CTA) Case No. 6188 promulgated on January 14, 2005, the CTA found the commission received by a domestic company from a related company to be arm's length. In this case, the Philippine company is a stockbroker/dealer in securities and it charges a 0.5% commission to its foreign clients but charges a lower 0.3% commission to its Hong Kong affiliate.

The CTA ruled that the lower commission charged to the Hong Kong affiliate is still considered an arm's length price. The Hong Kong affiliate is not under similar circumstances as other foreign clients are, considering that it performs certain services for the Philippine company such as marketing, research and assistance in certain transactions.

Likewise, in CTA Case No. 5908 issued on January 20, 2005, the CTA ruled that an arm's-length price for local sales may not be the same for export sales. A lower export price charged to an affiliate may be justified considering that domestic and export markets are two different markets. Export market is more competitive than local and the lower price to the affiliate is driven by competition. There were other compelling reasons for the lower price such as the need to meet export quota to retain Board of Investments (BOI) incentives, to earn dollars needed to fund importations, and to maximize production capacity. >

Dear Clients and Friends,

We are pleased to launch the first issue of **Focus**, a periodic publication specially designed to provide business executives of multinational corporations (MNCs) with current information on significant developments that may be used as additional inputs in evaluating business issues and decisions. This paper was conceptualized in response to the growing need of the business sector, especially foreign investors, to keep themselves abreast of developments that may affect their businesses.

This publication of Punongbayan & Araullo, member of Grant Thornton International, contains updates on common areas of interest including, but not limited to, taxation, accounting and finance, tax incentives, and labor and immigration. We invite you to e-mail us your comments and suggestions so that we could further improve this publication.



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Taxation (continued from page 1)

Arm's length price is the price an unrelated party would have paid under similar circumstances. The CTA recognized that there are many factors, i.e., the quality of the product, terms of sale, intangible property associated with the sale, timing, level of the market, and geographic factors that could affect the prices and make one dissimilar in circumstance with the other. The Bureau of Internal Revenue (BIR) cannot validly impute additional income to the Philippine company without examining the circumstances surrounding the transactions.

Availing of preferential tax treaty rates

A confirmatory ruling from the International Tax Affairs Division of the BIR is a requirement for the application of the preferential rates under tax treaties (CTA EB No. 40, June 7, 2005, on CTA Case No. 6382). The BIR ruling has to be issued in the name of the applicant, and the CTA emphasized that it is, therefore, erroneous for one taxpayer to invoke a ruling issued to another taxpayer.

The CTA denied the application for refund of an erroneously withheld tax on payment to a nonresident for failure of the Philippine company to present a BIR ruling. The CTA said that strict compliance with Revenue Memorandum Order (RMO) No. 1-2000 has to be implemented in line with the objective of the treaty parties to ensure that the benefits under the tax treaties are enjoyed only by the persons duly entitled to the preferential treatment.

This case is pending appeal with the Supreme Court (SC).

Taxing forex gains and scraps of PEZA firms

The Philippine Economic Zone Authority (PEZA) finally took a position (*PEZA Memorandum Circular No. 32-2005, September 15, 2005*) that the tax on incidental income shall follow the tax regime applicable to the activities from which the gains arise. Thus, if the forex gain is derived from an activity enjoying tax incentives (income tax holiday or 5% gross income tax), the incentive applies. Conversely, if the forex gain arises from activities subject to the normal corporate income tax, then the normal income tax applies.

The sale of production "rejects" and "seconds", and recovered waste/scrap from the production or processing of the registered products is considered within the registered activity of that enterprise and is likewise entitled to the same incentive enjoyed by the registered activity from which the scrap or waste arise.

However, the sale of unprocessed, unused, obsolete or "off-specs" production inputs is deemed not covered by the registered activity and shall be subject to the normal corporate income tax. ■

Accounting and Finance

Additional related party disclosures under new Philippine Accounting Standards

The new Philippine Accounting Standard (PAS) 24 on Related Party Disclosures took effect beginning January 1, 2005. This PAS requires that if there are transactions between related parties, the nature of the relationship and information about the transactions

currently available under the Omnibus Investment Code and other existing laws, and adopts a sunset provision for the proposed incentives.

Under the bill, the BOI shall be responsible for implementing the provisions of the proposed Code. It shall prepare the Investment Priorities Plan (IPP) and, as the national authority on investments, monitor and coordinate the investment promoting activities of all Investment Promotion Agencies (IPAs). The IPP shall identify the industries, services and other activities that shall be eligible for incentives under the proposed law, which, unlike in the present system, shall have a longer validity period of three years.

Investment Promotion Agencies. The bill grants the power to confer and administer investment incentives to all existing and future IPAs including the Philippine Economic Zone Authority (PEZA), Subic Bay Metropolitan Authority (SBMA), Clark Development Corporation, John Hay Management Corporation, Poro Point Management Corporation, Bataan Technology Park, Inc., Cagayan Economic Zone, PHIVIDEC Industrial Authority, and those previously declared as economic zones by virtue of presidential issuances.

Fiscal Incentives

Continuing moves to rationalize fiscal incentives

For years now, the Philippines has been trying to redesign its fiscal incentives system. Various structures have been proposed towards different objectives, among them, consolidating the incentive laws, entrusting implementation to one agency, focusing on priority sectors and projects, formulating more efficient schemes, and institutionalizing performance-based systems. The current initiative as embodied in House Bill No. 3295, also known as "The Consolidated Investments and Incentives Code of the Philippines," was passed by the House of Representatives on January 18, 2005. The salient features are discussed below, although the Senate may still come up with its own version of the rationalization measure. The new system, when legislated, will have prospective application and may, therefore, affect new projects and business expansions.

House Bill No. 3295 was passed with the objective of simplifying and establishing a time-bound and performance-based system. The bill puts into a single law the vast array of incentives

(such as amounts of the transactions) and outstanding balances with related parties should be disclosed. Even if there are no transactions between related parties, the nature of relationships between the parents and subsidiaries should be disclosed.

Changes under the new Standards. Compared with current requirements and practice, the new Standard expands the definition of ‘related party’ by adding:

1. Parties with joint control or significant influence over the entity
2. Joint ventures in which the entity is a venturer
3. Post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

The following additional disclosures are also required:

1. The entity’s parent and, if different, the ultimate controlling party
2. Key management personnel compensation in total and for each of the categories of employee benefits specified in the Standard
3. Bad debt expense recognized during the period on amounts due from related parties
4. Classification of amounts payable to, and receivable from, related parties into different categories of related parties (e.g., the parent, subsidiaries, associates, etc.)

Incentives to Registered Enterprises. A uniform set of fiscal incentives will be offered to all registered enterprises. This shall include income tax holiday or net operating loss carryover, accelerated depreciation, capital equipment incentives, tax credit on raw materials, tax and duty free importation of breeding stocks and genetic materials, deferred imposition of minimum corporate income tax (MCIT), and five percent tax on gross income earned in lieu of local and national taxes.

Other Fiscal Incentives. Activities listed in the IPP that exhibit high socio-economic returns may also be granted the following incentives after the lapse of the income tax-based incentives:

1. Investment tax allowance to the extent of actual investment, but not to exceed 30% spread within three years
2. Double deduction for local training expenses for five years
3. Double deduction for research and development expenditures conducted in the Philippines for five years

All related party transactions should be disclosed whether or not done on arm’s length basis. However, the standard clarifies that the report will only indicate that the transaction is on arm’s length basis if it can be substantiated.

Key management decisions. The financial statements will therefore include more detailed disclosures on related party transactions, and such disclosures will cover additional related parties. There are no specific transitional provisions. In this case, PAS 8 should be applied. Thus, information required by the new Standard should also be disclosed in comparative prior period FS. For first time adopters, PFRS1 should be followed.

Management needs to determine whether the present financial reporting system is adequate to identify related parties and capture related party transactions to ensure disclosure of required information under the new Standard. ■

Labor and Immigration

Relaxed requirement for Alien Employment Permit application

Nonresident foreign nationals occupying elective company positions in PEZA enterprises are required to apply for an Alien Employment Permit (AEP) within five days from the date of their election. The application requires a Special Non-Immigrant Visa that takes at least 15 days to secure. >

Duration of Fiscal Incentives. The enjoyment of the incentives shall be limited for a cumulative period of 20 years from the date of registration or start of commercial operation, except that it could be extended for industries deemed indispensable to national development. The sunset provision, however, does not apply to the tax-free and duty-free privilege of enterprises registered with the various economic, and freeport zones on their importation of capital equipment, raw materials, supplies and spare parts.

Non-Fiscal Incentives. The measure also offers non-fiscal inducements such as landing privileges to accredited airlines bringing in a large number of tourists to eco-tourism sites, and the issuance of investor’s visas for foreign nationals with minimum investments of US\$150,000 in a registered enterprise. On the other hand, foreign nationals employed in supervisory and technical positions, including their spouses and unmarried children under 21 years of age, shall be issued multiple entry visa. The latter shall also be exempt from obtaining all types of clearances, permits, licenses required by any government department or agency such as alien certificates of registration, emigration clearance certificates and alien employment permits. ■

Labor and Immigration

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The Department of Labor and Employment (DOLE) has agreed to relax this requirement. An application for AEP may now be filed even if they are in possession only of a Tourist or 9(a) Visa. The AEP will, however, be issued only upon presentation of the Special Non-Immigrant Visa approved by the Department of Justice. (PEZA Memorandum Circular No. 2005-30, September 9, 2005)

Replacement of ACR IDs with the microchip-based card before December 31, 2005

Beginning January 1, 2006, the Philippine Bureau of Immigration will honor only the new microchip-based Alien Certificate of Registration Identification Card or ACRI-Card (*BI Memorandum Order No. AFF 05-014, May 12, 2005*).

All registered aliens and their dependents are therefore advised to go to the Bureau of Immigration (BI) and exchange their paper-based ACRs on or before December 31, 2005 with the new ACR I-Card. The ACR I-Card is capable of storing and updating data electronically for faster documentation. It uses the biometric technology which makes it fraud and tamper-proof. Any alien found in possession of a paper-based ACR after December 31, 2005, shall be deemed not properly documented and may be accordingly penalized. The ACR I-Card may be renewed yearly and costs US\$ 50.00. ■

Developments to Watch

Regulations on transfer pricing

The BIR has presented for public comments a draft transfer pricing regulations pursuant to Section 50 of the Tax Code granting the Commissioner the authority to distribute, apportion or allocate gross income or deductions among related entities in order to prevent evasion of taxes or to reflect their true income.

The draft prescribes the guidelines for determining the true taxable income as well as the methods for allocating income and deductions among controlled organizations. More importantly, it lays down the minimum documentation necessary to verify compliance by taxpayers involved in the transfer pricing process.

Evaluation shall continue to rely upon the 'traditional methods', namely, the comparable uncontrolled price method, resale price method, and the cost plus method. When these cannot be reliably applied, the profit split method and transactional net margin method, commonly referred to as 'transactional profit methods', shall be used. Procedures on the application of advance pricing arrangements (APA) to minimize or resolve transfer pricing disputes between taxpayers and the BIR, and the BIR and tax administrations of other countries are also stipulated.

Specific rules are prescribed in cases of inter-related company transactions involving loans and advances, performance of service, and transfer/use of tangible/intangible properties.

Pending court decision on FCDU tax

A recent decision by the CTA could change the way foreign currency transactions of Foreign Currency Depository Units (FCDUs) with residents may be treated for tax purposes. In the case of [Deutsche Bank AG, Manila Branch vs. Commissioner of Internal Revenue] CTA Case No. 6566, (May 17, 2005), the CTA held that the commissions and gains earned by FCDUs from their foreign currency transactions with residents, other than from local commercial banks, branches of foreign banks, and other depository banks under the expanded foreign currency deposit system, are subject to the regular corporate income tax of 32% (now 35%), and not to the 10% final tax as provided under Revenue Regulations (RR) No. 10-98. The BIR has appealed the decision with the CTA *en banc* hearing the case, and if affirmed throughout the appeals process, it will cover all applicable foreign exchange transactions of FCDUs.

BIR rules on the use of functional currency financial statements

PAS 21 requires that beginning January 1, 2005, a Philippine entity shall use its functional currency in measuring its financial position and results of operations (i.e., measuring its transactions and recording the same in its accounting books). If an entity that qualifies for the use of a functional currency other than the Philippine Peso does not measure its financial position and results of operations using such functional currency, the financial statements (FS) will not be considered prepared in accordance with generally accepted accounting principles; the external auditor would, therefore, likely issue a modified auditor's report.

The standards define "functional currency" as the currency of the primary economic environment in which the entity operates or the currency in which sales, materials and other costs are denominated and settled. The Securities and Exchange Commission (SEC), earlier waived its requirement for prior SEC approval on the use of functional currency and the condition that "revenues, costs and expenses denominated in its functional currency represent at least 70% of the respective total."

The BIR, on the other hand, in the draft regulations presented for public hearing in October 2005, appears inclined to uphold that the Philippine Peso should still be the currency for recording the transactions and computing the taxes due. Thus, for tax purposes, the BIR may still require parallel books to be maintained in pesos and for tax returns to be filed using Philippine currency. ■