

Focus

For executives of multinational corporations

Punongbayan & Araullo 

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Taxation

Taxation of internationally mobile employees

The advent of technological changes in travel and communications has seen a growing trend among multinational companies to station expatriates in the Philippines, not only for local operations but also for businesses in the region and other countries. Similarly, we see an increasing number of Philippine employees being assigned to affiliates or project sites located in other countries, such as China, India, the U.S. or Europe.

The deployment of employees by multinational companies and their Philippine subsidiaries, whether in-bound or outbound, creates a host of issues, such as compensation structure, foreign benefits, employment permits and visa, retention and retirement issues, not the least of which is taxation. Such arrangements give rise to complicated tax situations affecting the tax liability of both the employees and the employers, as well as the host companies. New reporting responsibilities likewise arise, both under Philippine tax rules and the laws of the foreign country. All these tax issues should be considered prior to the implementation of foreign assignments so that pitfalls are avoided and appropriate planning opportunities are evaluated and carried out effectively.

Philippine outbound employees

Philippine income tax of the employee. Philippine income tax laws require a resident citizen to report income from all sources for tax purposes. Hence, in general, income received by a Philippine employee during the foreign assignment remains taxable in the Philippines and, thus, must be declared in the tax return. This applies regardless of whether his salary continues to be paid by the home company, or is paid fully or partially by the host company.

Excluded from this requirement, however, are Philippine employees who, because of their assignment, attain the status of nonresidents for tax purposes. Nonresident citizens, in addition to overseas Filipino workers (OFWs), certified as such by the Philippine Overseas Employment Agency (POEA), and seamen, are exempt from Philippine income tax on their foreign-sourced income. An employee shall be a nonresident if he stays outside the Philippines for a period exceeding 183 days in a taxable year. Once classified as such, he remains a nonresident until he returns to the Philippines.

The start and duration of the assignment of the Philippine employee will, thus, determine his Philippine tax responsibilities during the foreign assignment. Therefore, to enhance tax efficiency, consideration must be given to the start and end dates of the assignment.

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For additional information on the issues discussed in this publication, please contact:

Benedicta Du-Baladad
Tax Partner
19th Floor, Tower 1, The Enterprise Center,
6766 Ayala Avenue, 1200 Makati City
T +63 2 886-5511
F +63 2 886-5506; +63 2 886-5507
E Benedicta.Du-Baladad@pna.ph
W www.punongbayan-araullo.com

Foreign income tax of employee. Both the employee and the employer should, of course, consider that the employee may be exposed to income tax in the foreign country where he will be assigned, thereby affecting the total costs relating to the foreign assignment. In some countries, individuals are taxed based on the source rule, while in others, the tax is imposed based on residency. The tax laws of the country where the employee will be assigned have to be studied, and opportunities for exemption should be explored, including possible qualification for income tax exemption under the tax treaties that the Philippines currently has with 35 countries.

If the employee remains a resident for Philippine income tax purposes and as such required to pay Philippine income tax even on his foreign assignment income, he is allowed to claim any foreign income tax, on account of such foreign assignment income, as credit against his Philippine income tax, subject to certain limitations. However, he ceases to be entitled to foreign income tax credit once he qualifies as a nonresident.

Addressing tax costs. Because an employee could suffer or benefit from the combined taxes (home and/or host country taxes) on income during his foreign assignment, multinational companies often adopt a tax reimbursement policy that is meant to ensure that the employee neither benefits nor suffers as a result of his overseas assignment, thus making him tax neutral in respect to his decision on whether or not to take up international assignments. To accomplish this objective, an employer may choose to adopt either the tax equalization or tax protection program.

Tax protection of income. To handle the resulting tax cost to the employee arising from his foreign assignment, the company may

provide a tax allowance equivalent to the foreign income tax that the employee has to pay. Thus, compensation and other benefits given to him during the period of assignment are grossed-up with the foreign income tax, to the extent that these are taxable in the foreign country.

Tax equalization. A tax equalization program is commonly implemented to cover internationally mobile employees whereby the company shoulders the home and host country income taxes of the employee during the assignment period. In turn, the employee is required to pay a hypothetical tax, an amount equivalent to the income tax that he would pay had he stayed in his home country. In determining the hypothetical tax, the policy usually defines the compensation items that will be considered in the tax base. The hypothetical tax often covers only income taxes, although in other countries or with other employers, computation of the hypothetical tax may include social security taxes or contributions and local taxes.

Philippine income tax implications on the Philippine company. The impact of the foreign assignment to the Philippine company depends on how the assignment is structured. The employee may continue to be retained in the payroll of the Philippine company, or his ties can be severed through temporary secondment to the foreign affiliate. In the latter case, during the assignment period, the compensation of the employee is shouldered by the foreign affiliate.

In case the Philippine company continues to carry the employee in its payroll, it continues to be responsible for withholding the tax on compensation paid to the employee and remitting the same to the Philippine Bureau of Internal Revenue (BIR). Withholding should cease only if the employee qualifies as a nonresident citizen.

Taxation

Availing of exemption from social security coverage

With a few exceptions, social security coverage is compulsory for all employees, including expatriate employees.

However, exemptions can be availed if the expatriate employee is a resident of one of the countries with which the Philippines has a social security totalization agreement, namely, Austria, Belgium, Canada, France, Spain, Switzerland and the U.K. The employee only needs to submit to the Philippine Social Security System a certification from his home country's social security agency that he continues to be covered by his home country's social security system during his Philippine employment.

Although the annual social security contributions required of the employer (maximum of P11,000) and the employee (maximum of P6,000) are minimal, this is a relief negotiated and agreed upon to benefit residents of said countries and should therefore be enjoyed.

Development to Watch

Individual income tax reform

The level of individual income tax is as much a concern of the employees as the employers. For employers, income tax reduction or an increase in after-tax income relieves, to a certain extent, some of the pressure for wage increase. A move for higher taxes, on the other hand, may create the opposite effect. An income tax reform bill earlier passed by the Lower House of Congress moves the tax rates in both ways.

House Bill No. 5296, which is now with the Senate, seeks to restructure the taxation for individual compensation income earners towards the following directions:

- Increase in the top rate from 32% to 33% and 35%, exemption (0% rate) for net taxable income of up to P55,000 and reduction in the number of income tax brackets from seven to six. While the reform appears to align the individual

The Philippine company may claim the compensation as deduction for corporate income tax purposes provided that it is able to prove the necessity of the expense in pursuit of its business and substantiate the benefit derived from the foreign assignment of the employee.

Foreign country income tax implications on the Philippine company.

Assignment of employee to foreign posts may also expose the Philippine company to income tax in the foreign country if it derives income in connection with, or as a result of, the assignment. For example, a Philippine company with a contract to provide services in a construction project in Dubai deploys Philippine employees and pays their salaries and, in turn, is paid fees by the Dubai owner of the project. Under the tax laws of Dubai, nonresident foreign corporations are liable to pay income tax on income derived from sources within Dubai. Thus, in the example, the portion of the fees received by the Philippine company attributable to the services rendered by the Philippine employees assigned in Dubai shall be subject to Dubai income tax.

Thus, it is important for the Philippine company to consider such tax costs when structuring this type of contract. Otherwise, expected profits may be wiped out by the foreign corporate income tax.

If the foreign country is one of the countries with which the Philippines has a tax treaty, the income derived therefrom may be exempt from foreign country income tax, subject to compliance with the treaty conditions. Usually, under tax treaties, income is subject to tax in the source country only if a permanent establishment exists therein. A permanent establishment is a place maintained by the foreign company in

the other country from which it conducts business. It may include a branch, a construction project lasting for more than six months, or the performance of services by employees of the company for a period exceeding 183 days. With proper timing of the duration of the foreign assignment of the employee, therefore, foreign income tax can be avoided by the Philippine company.

Expatriates in the Philippines

Generally, expatriates who are required to secure a work visa must apply for this before taking up employment in the Philippines. It is therefore important that the expatriate's employment contract and benefit package is structured in a tax-efficient manner before the contract is submitted to the Philippine Bureau of Immigration.

Expatriates taking up employment in the Philippines will be subject to our comprehensive tax rules. Under the provisions of the Philippine Tax Code, the remuneration received by the expatriates in respect of the services they performed in the country is income taxable in the Philippines. Compensation for labor or personal services performed in the Philippines is treated as Philippine-sourced income, regardless of where the payment is made.

The tax rates and base depend on their tax classification. The tax rates for 2005-2006 are for:

- (a) Resident or nonresident aliens engaged in trade or business - graduated rates from 5% -32%

income tax with the corporate income tax, there is no provision similar to the corporate tax rate reduction to 30% beginning year 2009.

- Increase in personal and additional exemptions by 50%, from the current P20,000, P25,000, P32,000 and P8,000 for single, head of family, married individuals and for dependent children, respectively.
- Institutionalization of the tax exemption of specific thresholds for de minimis benefits which are currently prescribed under an administrative issuance.
- Increase in the ceiling for tax-exempt 13th month pay and other benefits from P30,000 to P45,000

The proposed system is primarily designed to exempt minimum wage earners and reduce the tax burden for lower income groups, not for higher income earners. For taxpayers in the 32%

tax bracket, the proposed increase in personal and additional exemption allowances will not be sufficient to offset the impact of the higher tax rates. The current 32% rate is already considered by many to be high; 35% is simply onerous.

The Senate, on the other hand, has expressed an inclination for further simplification of the structure by exempting income up to P200,000 and imposing a flat rate of 35% on the excess.

Many, of course, are hoping that there will still be room for further polishing to achieve the objectives of providing relief to low income earners without imposing additional burden on other individual taxpayers.

This legislation is targeted to be enacted within the year and to apply retroactive to January 1, 2006 income. In anticipation, the Department of Finance already exempted minimum wage earners from the coverage of the withholding tax.

- (b) Nonresident aliens not engaged in trade or business - final tax of 25% on gross income

A preferential rate of 15% on gross income is imposed on alien employees of regional or area headquarters, regional operating headquarters of multinational companies, offshore banking units, and foreign service contractors and subcontractors in petroleum operations in the Philippines.

In general, all forms of compensation income received for services rendered under an employer-employee relationship are taxable. Compensation income includes, but is not limited to, salaries, wages, emoluments and honoraria, allowances, commissions, fees including director's fees if the director is also an employee of the corporation, bonuses and fringe benefits except those that are subject to fringe benefits tax (FBT), taxable pensions and retirement pay. Certain types of compensation are exempt from tax - up to P30,000 of the 13th month pay, productivity incentives and Christmas bonuses, compensation from injuries or sickness, retirement benefits under a private benefit plan, Medicare and other mandatory contributions. The FBT is imposed on fringe benefits, in cash or kind, given to managerial and supervisory employees. Benefits provided that are necessary for the trade or business of the employer, or for the convenience of the employer, and *de minimis* benefits are not subject to FBT.

A foreign national, whether resident or nonresident, is only subject to income tax on Philippine-sourced income. As such, no credit for income taxes paid on such income to foreign countries is allowed against Philippine income tax.

Relief from Philippine income taxes. Expatriates who are residents of countries with which the Philippines has existing tax treaties may qualify for exemption from Philippine income tax if the treaty conditions, which usually include the following, are satisfied:

- (a) the employee is present in the country for a period or periods not exceeding 183 days in the calendar year concerned;
- (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the country; and
- (c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the country.

All the conditions must be satisfied in order for the remuneration to qualify for exemption. This exemption is generally enjoyed by expatriates on short-term assignments in the Philippines that do not require them to be employed by the Philippine host company.

Expatriates claiming exemption from Philippine income tax by virtue of tax treaty provisions are advised to secure a tax ruling from the BIR.

Philippine income tax implication on foreign company.

If the expatriate remains an employee of the foreign company, the latter should consider whether the assignment will attract Philippine income tax for itself. Any income that the foreign company may derive in connection with the services performed by the expatriate in the Philippines is considered Philippine-sourced income, for which the foreign company is liable to pay the final tax of 35% on gross income.

Management and technical service agreements are typical examples of these types of transactions. Normally, the foreign company sends its employees to the local company to render the services covered under the agreements. The service fees received by the foreign company attributable to the services rendered by the expatriates in the Philippines are subject to Philippine income tax. Tax relief is available under the tax treaties and should therefore be explored. ■

Corporate Registration

What's your address?

Corporations registering with the Securities and Exchange Commission (SEC) to do business in the Philippines are now required to have a specific address indicating the street name and number, barangay, and city or municipality (SEC Memorandum Circular No. 3, February 16, 2006). A general address such as "Metro Manila" is no longer acceptable.

While an exact address seems to be a simple detail, requiring this at a very early stage in the process of setting up, and while the company does not even have a legal personality yet, consumes additional time and resources and requires decision-making. A corporation planning to register to do business in the Philippines should realize this and be prepared to settle the issue with the people handling its registration. ■

Accounting

Use of functional currency FS for tax purposes

Policies and procedures have been issued under Revenue Regulations No. 06-06 (May 3, 2006) to govern taxpayers adopting a functional currency, other than the Philippine peso, in its financial statements (FS) that will be submitted to the BIR and in the books of accounts that it will maintain for purposes of compliance with internal revenue tax rules.

The regulation specifically provides retroactive application. Hence, taxpayers who have adopted functional currency financial statements for 2005 and prior years are well advised to review such submissions and evaluate whether there is a need to amend such returns to comply with the regulations. ■