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## **Interest: Legal rate vs arm's-length rate**

INTEREST is said to be the wife of loan. A simple loan is a contract where one party delivers money or other consumable thing to another party, with the understanding that the same amount of the same kind and quality shall be paid. In every loan agreement, the payment of the principal usually carries with it the payment interest. If the parties agree on the rate of interest, that agreement is binding between them. In the absence of such an agreement, the interest due shall be the legal rate of interest.

The current legal rate of interest on loan transactions, based on Bangko Sentral ng Pilipinas (BSP) Circular 799, is 6 percent per annum. Effective July 1, the legal rate of interest for any loan or forbearance of money, goods or credits and the rate allowed in judgments shall be 6 percent per annum in the absence of an express contract on such rate of interest. It is implied that the parties can set the interest at an agreed rate (even a zero-percent rate) and that should govern their transaction. And if there is an agreement to impose interest but no rate is specified, the legal rate will apply. Will this rule apply for taxation purposes?

Based on Section 50 of the Tax Code, the commissioner of internal revenue (CIR) is authorized to distribute, apportion or allocate gross income or deductions between or among two or more organizations, trades or businesses owned or controlled directly or indirectly by the same interests, if he determines that such distribution, apportionment or allocation is necessary in order to clearly reflect the income of any such organization, trade or business. On the strength of this provision, the Bureau of Internal Revenue (BIR) issued Revenue Regulations 02-2013, which seek to provide guidelines in applying the arm's-length principle for cross-border and domestic transactions between associated enterprises.

Thus, the CIR is authorized to make transfer-pricing adjustments, in line with the purpose of Section 50 to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. With respect to interest, the fact that the interest rate actually charged on a loan or advance is expressly indicated on a written instrument does not preclude the application of Section 50 to such loan or advance.

Thus, the BIR may impute interest on the transaction, at rate/s even higher than the legal rate of interest. Based on an earlier revenue memorandum order, the arm's-length interest rate shall be the rate of interest that was charged or would have been charged at the time the indebtedness arose in independent transaction with or between unrelated parties under similar circumstances. All relevant factors will be considered, including the amount and duration of the loan, the security involved, the credit standing of the borrower and the interest rate prevailing at the situs of the lender or creditor for comparable loans. But for purposes of determining the arm's-length rate in domestic transactions, the interest rate to be used is the Bank Reference Rate prescribed by the BSP.

The power of the CIR to distribute, apportion or allocate gross income or deductions between or among related parties may, indeed, include the power to impute theoretical interest on interest-free loans or impute additional interest on interest charged below the arm's-length rate. Since transfer-pricing regulations are already in effect beginning 2013, taxpayers should expect possible adjustments by the BIR on interest charged on related-party transactions.

The tax collector, however, should respect the issuances of other authorities and judicial pronouncements on the issue. With the BSP's reduction of the legal rate of interest from 12 percent to 6 percent, the tax authority should follow the same rate as the arm's-length rate. There was also an earlier decision by the Supreme Court in CIR v. Filinvest Development Corp., (G.R. 163653 and 167689, July 19, 2011), holding that, despite the broad parameters provided to the commissioner, this power of distribution, apportionment or allocation of gross income and deductions does not include the power to impute "theoretical interests."

While the arm's-length rate of interest can be easily determined, taxpayers who transact with related parties are advised to maintain adequate transfer-pricing documentation to demonstrate that their transfer prices are consistent with the arm's-length principle, including the determination of the rate of interest.

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