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Transfer Pricing Survey on management fees

IN my previous article, published in October 2012, I discussed transfer pricing (TP) in the Philippines, pending the finalization of TP regulations. On January 3 the Department of Finance finally issued these regulations, which are embodied in Revenue Regulations (RR) 2-2013.

Though relatively new in this field, the Philippines is among the 79 countries that participated in the Transfer Pricing Survey, which was conducted by the World Tax Services (WTS) Alliance. Published on November 18, the survey centered on the tax treatment of intra-group management service fees, which apparently is also the increasing area of concentration during tax audits.

Based on the Organization for Economic Cooperation and Development's (OECD) TP guidelines, the service provider must be able to show through appropriate documentation that an actual service has been provided, that the service provides a benefit to the recipient and that the service charge does not include shareholder costs.

The WTS survey showed that in more than 60 percent of the countries, the Philippines included, appropriate transfer-pricing documentation is required to document the intra-group (management) service charge. Such TP documentation is merely or highly recommended in more than 30 percent of the participating countries. However, TP documentation would not yet be necessary in countries such as Bahrain, Cyprus, the Czech Republic, Malta and the United Arab Emirates.

In order to ensure that a service charge is acceptable, the so-called benefit test is applied—that is, whether or not the activity provides an economic or commercial value to enhance a group member's commercial position.

The service-fee charges must be compliant with the arm's-length principle. According to the survey, 75 percent of the participating countries responded that the cost-plus method can be applied. However, in some countries, other methods are mentioned as appropriate, especially the transactional net-margin method. Pursuant to Section 7(b)(2) of RR 2-2013, our country has adopted the so-called best method rule. In order to substantiate the arm's-length character of the charge, a benchmark study is, at least, recommended in more than 75 percent of the countries; in 18 countries, including the Philippines, it is even required.

The survey concluded that it is essential to appropriately document the intra-group (management) service charge. Otherwise, companies will be subject to the perils of double taxation or litigation, tax adjustments, penalties and interests, as well as reputational risks.

It was noted, however, that there exists no uniform, globally accepted way for the allocation of management service fees. This is largely attributed to differences in the local interpretation of the OECD guidelines or differences in local legislation, as well as diverse opinions on the applicability of the TP methods. This is further augmented by the different levels of expertise on transfer pricing, as can be gleaned from the fact that only 40 percent of the countries have a developed advance-pricing agreement (APA) program. Section 11 of RR 2-2013 provides that the Bureau of Internal Revenue will issue separate guidelines on the APA. To date, however, none has been circulated.

Concrete examples of diverging views are manifested on various issues captured by the WTS survey, such as the acceptability of the method of cost allocation. Almost 80 percent of the participating countries accept the application of the direct and indirect methods. The other countries either accept the direct-charging method or do not have legislation and/or experience with this.

Another is on profit margins. The survey showed that the profit markups applied in the world range from 0 percent to 30 percent, but most countries indicate that the profit markup generally ranges from 5 percent to 10 percent. This is in line with pan-European benchmark studies recently performed by WTS Alliance in Europe. The profit markup should, in principle, not be applied to costs that have a disbursement nature or are reimburseable.

When charging (management) service charges, withholding taxes also need to be taken into account. In about 50 percent of the countries, withholding taxes are or could be due on the service charge, ranging from 0.6 percent to 30 percent.

It is with high hope that this WTS survey will eventually lead to the global implementation of a uniform policy on the allocation of management service fees.

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