Transfer Pricing update: current treatment of management services to Philippine companies

The introduction of the Revenue Memorandum Circular (RMC) No. 5-2024 for Tax on Cross-Border Services in the Philippines earlier this year, has resulted in an important change in the taxation of foreign services provided to Philippines subsidiaries.

In this short paper, we explore the current treatment of management services by foreign companies – in a Q&A format.

Questions:

1. **What recent changes have you observed in the local treatment of management services charges from foreign companies to taxpayers in the Philippines?**

   Early 2024 saw the issuance of one of the most controversial tax rules of the Bureau of Internal Revenue (BIR): Revenue Memorandum Circular (RMC) No. 5-2024, otherwise known as the Tax on Cross-Border Services.

   RMC No. 5-2024 sought to impose a final withholding tax and a final withholding VAT on services performed by non-resident service providers, under the assumption that these services are taxable in the Philippines. The BIR's premise is that the services rendered by the non-resident service providers are taxable in the Philippines as long as the services are utilised in the Philippines - regardless of where the actual service was performed. This premise is apparently in line with a Supreme Court decision tackling the taxation of the services rendered by a company offering satellite phone services.

   Although later issuances of the BIR would affirm that RMC No. 5-2024 does not automatically apply to international service provision or cross-border services, this is not reflective of what is happening on the ground, as taxpayers are slowly being assessed for understating withholding taxes payable in relation to the services provided.

   A case was filed in court questioning the validity of RMC No. 5-2024, but it was recently dismissed due to procedural defects and a reconsideration of the dismissal is currently pending.

2. **What administrative issuance applies for taxation for Electronic Marketplace Operators and Digital Financial Services; and Cross-Border Services?**

   Some of the most notable administrative issuances are as follows:

a. Revenue Regulations No. 16-2023 – which imposes the withholding tax on gross remittances made by e-marketplace operators and digital financial service providers to sellers/merchants as well as the mandatory registration requirements;
b. Revenue Memorandum Circular Nos. 8-2024, 55-2024, and 79-2024 – which clarifies certain issues on Revenue Regulations No. 16-2023, as well as provides extensions on the actual imposition of the withholding tax.
c. Revenue Memorandum Circular No. 5-2024 – imposes the final withholding tax and final withholding VAT on cross-border services rendered by non-resident foreign service providers but utilised in the Philippines; and
d. Revenue Memorandum Circular No. 38-2024 – clarifies certain issues raised in RMC No. 5-2024.

3. What taxes apply to the provision of digital services under the new Digital Services Act in the Philippines (for both resident and non-resident service providers)? Can you provide examples?

The new Philippine Digital Services Tax seeks to impose a 12% value-added tax on "digital services" consumed within the Philippines. The term "digital services", refers to services that are supplied over the internet or other networks (with the use of IT) - and such services are largely automated. Examples include online search engines, electronic marketplaces, cloud services, online media and advertising, online platforms, and digital goods.

Note however, that the draft implementation rules and regulations would appear to require that the 12% VAT is applied to traditional services that are transmitted through the internet. Discussions are still being conducted to determine the appropriate limit to which "digital services" are covered by the new law.

4. What taxes are imposed on services performed by non-resident foreign service providers and how does this imposition represent a shift in what constitutes services performed within the Philippines?

The enactment of the Digital Services Tax shows a shift in the concept of the "place of performance of services" for the purposes of imposing a VAT tax. Before the enactment of the new law, services were taxable in the Philippines only if these are actually rendered or performed in the country.

However, with the advent of the electronic means of delivering services, a shift is necessary. The new law has modified the place of performance, insofar as digital services now include those services that are consumed in the Philippines. It should be noted that this shift required the enactment of a new law.

In contrast, RMC No. 5-2024, which likewise seeks to change the concept of performance of services to include use/utilization in the Philippines, is only an administrative issuance.

5. With the growing transfer pricing audit capability and increased scrutiny on cross border transactions, do you expect to see an increased number of

audits on service transactions? Have you noticed an appreciable increase at this time?

Transfer pricing issues have been slowly appearing in the regular audits of the BIR, although scrutiny is generally limited to (i) only specific types of transactions, such as imposing interest on non-interest bearing loans, or (ii) questioning transfer pricing benchmarking study (e.g. revalidating the chosen comparables for the study). That said, a full transfer pricing audit may not yet be within the capabilities of the BIR, currently.

However, considering that the BIR is receiving assistance from international agencies in its transfer pricing capacity building, we expect that the BIR may be actively performing transfer pricing audits in the near future.

6. **You have noted an increased preference for local comparables versus regional or international comparables. Does this preference apply to the provision of both low- and high-value services?**

Yes. The use of local comparables is the standard approach adopted by the BIR. Interestingly, the transfer pricing rules and transfer pricing audit procedures of the BIR were reproduced from the OECD Model Rules. However, the BIR failed to update its rules when significant developments and administrative guidance were released. One of these developments included the adoption of safe-harbour rules and the distinction between low- and high-value transactions.

As such, the high level of scrutiny applied is consistent for all related party transactions, regardless of its nature or amount. This includes the preference for local comparables.

7. **How amenable is the Philippines Tax Authority to accepting application of low-value safe harbour mark-ups on costs, as often applied by Singapore service providers?**

Unless the local transfer pricing rules are amended, application of safe-harbour mark-ups or other distinctions based on whether transactions are low- or high-value, would not be recognised by the BIR. The current transfer pricing rules require that taxpayers defend their transfer pricing, regardless of the amount of the transaction.

8. **What are the most common areas of audits in relation to management services charges, presently? Do you expect to see any additional areas of audit in the future?**

With the issuance of RMC No. 5-2024, taxpayers may experience an increased scrutiny for all cross-border services, not just management services. The scope of RMC No. 5-2024 is broad, since it refers to "international service provision." Further, there are observed instances wherein RMC No. 5-2024 is being applied retrospectively. This may make RMC No. 5-2024 a critical issuance for taxpayers who have relied upon the prevailing doctrine (i.e. place of performance of service determines taxation) - at the time they entered into the transaction.

In addition, e-marketplace operators and digital financial services providers must take note of (i) their obligations to withhold taxes on sales/transactions by their online merchants/ sellers, (ii) their administrative obligations to keep track of the merchants' transactions, and (iii) to make sure that they are duly registered with the BIR.

9. On the issue of withholding tax on services - what practical advice will you give to taxpayers on this issue, given that there should not be withholding tax on services performed overseas?

The clarifications issued by the BIR, state that not all cross-border services are subject to withholding tax. Specifically, the withholding tax is only imposed, when there is an economic activity in the Philippines.

We normally advise our clients to not pay the withholding tax, if the services by the non-resident supplier were clearly performed outside the Philippines. To this end, it would be best if the intercompany contract/agreement and the related billings would show or otherwise have some indication that the services were performed outside the Philippines.

10. Is there withholding tax on payment to overseas freight forwarders for international freight with the latest development on withholding tax on services?

No, the withholding tax should not be applicable since the service is performed outside the Philippines.

In conclusion, we recommend that internationally headquartered companies providing services to your subsidiaries in the Philippines, take note of the new taxes and where the services are provided offshore, to clarify this fact in the intercompany agreements.

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