Current account deficit could narrow on cheaper PHL imports

THE current account deficit has a chance of narrowing this year as commodity prices fall, but weaker exports as the global economy slows could ultimately keep the indicator in the negative, analysts said.

Makoto Tsuchiya, assistant economist from Oxford Economics Japan, said the firm expects the current account deficit as percentage of gross domestic product (GDP) to settle at 2.7% this year and 3.3% in 2024.

Both forecasts are more positive than the projections of the Bangko Sentral ng Pilipinas (BSP), which sees a $17.1-billion deficit (4% of GDP) for this year and a $16.8-billion deficit (3.4% of GDP) for 2024.

"The forecast represents an improvement from last year given lower commodity prices, but the balance will remain in deficit given slowing goods exports on the back of weaker global economic outlook and the lower demand for electronics, particularly semiconductors, amid an IT cycle downturn," he said.

The BSP put the current account deficit at $17.8 billion in 2022, widening from the $5.9-billion deficit in 2021, as the trade in goods deficit widened.

China Banking Corp. Chief Economist Domini S. Velasquez said the current account deficit may narrow over the coming months due to a declining trade deficit.

"Merchandise exports likely bottomed out in the first quarter and will improve moving forward. Recent trade data showed Chinese export demand picking up which will likely continue through the rest of the year," she said in a Viber message.

The country's trade-in-goods deficit in March widened to its highest level in two months as exports and imports continued to fall.

The Philippine Statistics Agency reported that the trade-in-goods balance was in deficit by $4.93 billion in March, widening from the $3.91-billion deficit a month earlier and the $4.59-billion deficit a year earlier.

Goods exports declined 9.1% year on year to $6.53 billion in March, reversing the 6% year-earlier rise, while imports dropped 2.7% year on year to $11.46 billion, turning around from the 23.4% growth in March 2022.

For the first quarter, exports declined 13.2% to $16.86 billion, while imports slipped 3.3% to $31.44 billion. This brought the trade deficit to $14.58 billion during the quarter, wider than the $13.08-billion deficit from a year earlier.

"In lieu of the weak merchandise exports this year, we expect the trade deficit to receive support from improving services exports led by BPOs (business process outsourcing companies) and tourism. Also, imports will be softer this year, as oil prices settle lower," Ms. Velasquez said.

She added that dollar reserves are above $100 billion, allowing the Philippines to meet its external debt obligations and provide the BSP with the resources to mitigate excessive peso volatility.

The BSP said reserves edged higher to $101.8 billion at the end of April from $101.5 billion a month earlier.

Rizal Commercial Banking Corp. Chief Economist Michael L. Ricafort said the recent decline in prices of key global commodities which the Philippines imports could lead to a narrower current account deficit this year.

These commodities include crude oil, other energy items and industrial metals.

"At the same time, the continued growth in structural dollar inflows... would also help narrow the current account deficit going forward," he said.

Mr. Tsuchiya said a weaker-than-expected global economy, weak exports, risks to tourism and slower growth in cash remittances may negatively affect the current account balance.

"If the global economy slows further than we expect, and consequently Philippines goods exports are weaker than expected, then this will bring down the current account balance deeper into deficit," Mr. Tsuchiya said.

He also said that a deterioration in the current account deficit will raise the pressure on monetary authorities to cut rates.

"A deeper deficit will put downward pressure on the peso, which in turn might (compel) the BSP's move to cut rates, (which will) lead to further depreciation of the currency if it results in a narrower interest rate differential with the Fed," he said.

The Monetary Board kept its benchmark interest rate unchanged at 6.25% on May 18. This is the first time it has left rates steady after nine meetings.

Since it began its tightening cycle in May 2022, the BSP has raised borrowing costs by a total of 425 basis points (bps). The BSP's next policy meeting is June 22.

The Federal Reserve has raised borrowing costs by 500 bps since March 2022, bringing the Fed funds rate to 5-5.25%. The Fed is set to meet on June 13-14.

"Fiscal implications are also important, as the Philippines already suffers from its status as a twin deficit economy. Although Fitch Ratings recently upgraded the outlook for the Philippines to stable from negative, a wider current account deficit will increase pressure on the government to compress its fiscal debt," Mr. Tsuchiya added.

The Bureau of the Treasury reported that the fiscal deficit narrowed 14.51% year on year to P270.9 billion in the three months to March.

The government had projected a deficit for the period of P298.705 billion.

This year, the government has set a budget deficit ceiling of P1.499 trillion, equivalent to 6.1% of GDP.

In its rating action commentary last week, Fitch Ratings said it expects the Philippine current account deficit to narrow to 2.3% of GDP in 2024.

"We expect the current account deficit to narrow to 2.3% of GDP (about $11 billion) by 2024, from an estimated 4.4% of GDP (nearly $18 billion) in 2022, reflecting mainly a falling hydrocarbon import bill, which accounted for the spike in the deficit in 2022," it said.

However, the current account deficit will persist amid robust domestic demand and the government's infrastructure push.

A significant deterioration in gross international reserves and net external creditor position due to a persistent current account deficit may lead to a rating downgrade, Fitch Ratings said.

Last week, the credit rater kept the Philippines' long-term foreign currency issuer default rating at "BBB" and upgraded its outlook to stable from negative. — **Keisha B. Ta-asan**

BoC gearing up for increased EU trade

THE Bureau of Customs (BoC) said it is getting ready for strengthening trade and investment between the Philippines and Europe by making transactions more seamless.

In a statement on Monday, the BoC said it has entered into a partnership with the European Union (EU)-ASEAN Business Council and the European Chamber of Commerce of the Philippines.

"This collaboration represents a significant milestone in our efforts to strengthen economic ties with European businesses. By enhancing our modernization program and streamlining our processes, we aim to create a seamless and efficient trade environment that benefits both parties," Commissioner Bienvenido Y. Rubio said.

The BoC is working on "fostering a conducive business environment, facilitating trade, and promoting mutual prosperity between the Philippines and its European partners."

"With this collaboration, it aims to position the Philippines as a premier destination for European businesses, creating opportunities for both regions," it added.

The BoC is also working on transitioning to paperless transactions and streamlining clearance processes for donations during calamities.

On Thursday, President Ferdinand R. Marcos, Jr. called for the resumption of free trade talks with the EU. The negotiations officially started in 2016 but were suspended a year later. — **Luisa Maria Jacinta C. Jocson**

British Chamber sees electronics, fruits gaining from trade scheme

THE British Chamber of Commerce Philippines (BCCP) said the UK's new trade scheme will benefit Philippine products like electronics and processed fruit with the launch of a new trading scheme on June 7.

BCCP Executive Director Chris Nelson said that the Philippines could climb the ranks of UK trading partners with the launch of the Developing Countries Trading Scheme (DCTS).

"There is significant trade in electronics, coconut oil, processed fruit, and spectacle lenses. Currently, the Philippines is ranked 64th in terms of the trade with the UK. I can see that going up significantly," Mr. Nelson said.

UK government data puts Philippine exports to the UK at 2.4 billion pounds in 2022, up 26%.

The DCTS will replace the UK's Generalized System of Preferences trading scheme. The new trading scheme will benefit 65 developing countries.

"The DCTS will be removing 150 of the tariff lines. It will cover an area of over 3.3 billion people. Particularly for the Philippines, it will continue to grow trade that's already doing extremely well," Mr. Nelson said.

"The Philippine economy will continue to grow and do well, and that's also supported by the various economic reforms that have occurred, and we see further liberalization occurring," Mr. Nelson added. — **Revin Mikhael D. Ochave**

Budget dep't threatens to deny funding in 2024 to underspending agencies

BW FILE PHOTO

THE Department of Budget and Management (DBM) said government agencies need to ramp up their spending after noting the slower pace of budget utilization.

"We want to remind our agencies to avoid underspending, given our very limited fiscal space. Again, we need to instill discipline in our National Government agencies or we shall put the money into agencies which can really implement them," Budget Secretary Amenah F. Pangandaman said in a statement.

"As early as the start of the year, we emphasized that only implementation-ready proposals will be included in the 2024 budget," she added.

At the end of April, the budget utilization rate was at 90%, equivalent to P1.18 trillion worth of notices of cash allocation (NCAs) issued during the period. This was behind the 92% pace set a year earlier.

Unused allocations totaled P128.07 billion at the end of April.

NCAs are a quarterly disbursement authority that the DBM issues to agencies, which allows them to withdraw funds from the Treasury to support their spending needs.

The DBM had released 85.8% or P4.52 trillion of the 2023 national budget at the end of April, leaving P749.85 billion for the remainder of the year.

This was slightly ahead of the year-earlier pace of 85.6%.

Releases to government agencies and departments totaled P2.98 trillion, or 94.8%.

"We all know that our national budget is the lifeblood of all government programs and projects. The faster we disburse and utilize our funds, the faster we can procure and implement our projects," Ms. Pangandaman added. — **Luisa Maria Jacinta C. Jocson**

OPINION

BIR's transfer pricing audit history

LET'S TALK TAX
MARIE FE F. DANGIWAN

In our previous article "BIR transfer pricing audits — the next wave?," we looked into Revenue Audit Memorandum Order (RAMO) No. 1-19 which is the current regulation in force when it comes to Transfer Pricing (TP) audits. The RAMO explained in detail how the Bureau of Internal Revenue intends to conduct its audit of related-party transactions.

In my experience so far, only a few BIR officers have tried to include TP findings in their tax investigations, or at least discussed how related party transaction (RPT) prices are derived. Because the RAMO was introduced in 2019, no TP controversies have reached the courts as yet.

Confucius once said that anyone who wants to define the future must study the past, because without history, there is no future. As such, any glimpse into the future of TP audits should begin with a study of what came before. What can taxpayers glean from past TP cases in preparing for TP audits in the future?

BURDEN OF PROOF LIES WITH THE TAXPAYER

In a 2005 Court of Tax Appeals (CTA) case, the BIR used the taxpayer's documents to scrutinize the prices of products sold to both related and unrelated parties. Based on the documents, the BIR concluded that the taxpayer did not declare all its export sales, based on the price comparison it conducted.

The requirement of scrutinizing taxpayer documents has been reiterated in the RAMO guidelines. Among the initial audit steps is for the BIR to schedule a meeting with the taxpayer to gain an understanding of the taxpayer' data with respect to its transactions with related parties and transfer pricing policy. Examination of contracts, audited financial statements, income tax returns, and BIR Form No. 1709 (Information Return on Transactions with Related Party), among others, must be conducted to collect additional information.

More importantly, the BIR may request and analyze the taxpayer's TP documentation (TPD) especially if the taxpayer is required to maintain such files based on the criteria set by the BIR. Compliant TPD must be contemporaneous. This means that it is brought into existence at the time the related parties develop or implement any arrangement that might raise transfer pricing issues, or review these arrangements when preparing tax returns, or not later than the deadline to file the annual income tax return.

Since the taxpayer has the burden to prove that the related-party transactions comply with the TP rules, it is best for the taxpayer to maintain TPD and other relevant records and have these ready for a possible TP audit.

COMPARABILITY AND FAR ANALYSIS

In a 2005 CTA case, the BIR asked a taxpayer why prices offered to foreign affiliates were lower than domestic prices. The taxpayer explained that the domestic selling price is not a benchmark price for export sales because export and domestic markets are different. For one, the export market is competitive while the domestic market is a captured market. Another reason is that to beat quotes of other sellers with lower production costs than those of the Philippines, the taxpayer offers lower mark-ups on export products in order to get the business and in the process maximize the utilization of its production facilities. Finally, the taxpayer said export sales maximize productivity, which in turn results in a lower unit cost of production as fixed overhead is spread over larger volumes.

The above reasons were found by the Court to justify setting a lower price for exports. Thus, the Court ruled in favor of the taxpayer.

The RAMO guidelines provide that the BIR officer conducting the audit should be able to draw conclusions about the characteristics of the taxpayer's business and the functions performed by related parties, and to examine the appropriateness of the remuneration received by the taxpayer and related parties relative to the functions performed, assets used, and risks borne by each party through review and analysis of accounting data, interviews, plant tours and site visits.

The BIR may also perform a comparability analysis. That is the audit in transfer pricing that compares the condition of related-party transactions and that of independent transactions. Accordingly, the taxpayer should include in its documents reasons that make commercial sense if there are differences in the pricing policies.

In summary, taxpayers should be thoroughly familiar with the characteristics of their products or services and their comparability with other products or services offered to independent parties or offered in an independent transaction. Understanding the functions, assets, and risks is crucial because this would lead to the correct characterization of the taxpayer's business operations and expected level of return.

BE FAMILIAR WITH THE TP RULES

In a 1995 CTA case, the BIR alleged that the taxpayer overstated its cost of goods due to the transfer pricing of products to its mother corporation. Specifically, the BIR alleged that a fourth-generation antibiotic should not be allowed to incur costs of improvement eight times higher than its supposed precursor, doxycycline, a third-generation antibiotic.

The taxpayer was able to demonstrate the physical characteristics and circumstances involved in the production of minocycline, a completely different kind of antibiotic from doxycycline, with each one having a separate and unique chemical structure and production process. Also, the development costs of both antibiotics are different. The taxpayer contended that there is no sufficient basis to compare the two as they are not in the same generation of antibiotics. The taxpayer explained that the cost of improvement for minocycline should be gauged against another fourth-generation tetracycline developed likewise from Declomycin in order to produce comparable and reliable data.

In this case, the taxpayer challenged the transfer pricing method used by the BIR in deriving its TP findings. Needless to say, taxpayers should be familiar with the tax rules so they can intelligently defend their related party transactions, TP policy and TPD.

Under the RAMO guidelines, specific rules need to be followed by the taxpayer and BIR examiners. These include the selection of TP methods. In the antibiotic case, the BIR was imposing the comparable uncontrolled price (CUP) method in determining the arm's-length price. However, the same seems not applicable because of the differences in the characteristics and circumstances surrounding the taxpayer's products, which could have a material impact on the price of goods.

KNOW MORE ABOUT TP AUDIT PREPARATION

P&A Grant Thornton will be offering a free webinar on June 20, 2023, "Am I TP audit ready?" We hope we can help taxpayers in preparing their companies for possible TP audits in the future. Join us in our discussion.

Let's Talk TP is an offshoot of Let's Talk Tax, a weekly newspaper column of P&A Grant Thornton that aims to keep the public informed of various developments in taxation. This article is not intended to be a substitute for competent professional advice.

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