

REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE

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D R A F T

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REVENUE REGULATIONS NO. _____

SUBJECT: Revenue Regulations Implementing the Provision of Section 50 of the National Internal Revenue Code of 1997 Pertaining to the Power of the Commissioner of Internal Revenue (Commissioner) to Allocate/Distribute Income and Deductions of Inter-related Organizations, Trades or Businesses or Related Parties Having Transactions with One Another to Reflect their True Income

TO: All Internal Revenue Officers and Others Concerned

SECTION 1. SCOPE. – Pursuant to the provision of Section 244 in relation to Section 50 of the National Internal Revenue Code (Tax Code) of 1997, these regulations are hereby promulgated to: (i) implement the authority of the Commissioner of Internal Revenue (Commissioner) to review controlled transactions among related parties and to allocate/distribute related parties' income and deductions in order to determine the true taxable income of the related parties involved in controlled transactions; (ii) prescribe the guidelines in determining, according to the standards of an uncontrolled transaction, the true taxable income of the parties in the controlled transaction by providing for the methods in verifying or establishing the arms length price/standard for transactions between/among related parties; and (iii) provide for the maintenance/keeping of the documents necessary for the taxpayer to prove that efforts were exerted to determine the arms length standard in measuring transactions among members of inter-related organizations, trades or business entities or, in short , among related parties.

SECTION 2. AUTHORITY OF THE COMMISSIONER TO ALLOCATE INCOME AND DEDUCTIONS. – Section 50 of the Tax Code provides that in the case of two or more organizations, trades or businesses (whether or not incorporated and whether or not organized in the Philippines) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion or allocate gross income or deductions between or among such organization, trade or business, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organization, trade or business.

SECTION 3. DEFINITION OF TERMS. – As used in these Regulations, the following terms shall have the following meaning:

Controlled parties/related parties. Two enterprises are related/associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other; or if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

Control refers to any kind of control, direct or indirect, whether or not legally enforceable, and however exercisable or exercised. It is the reality of the control that is decisive, not its form or the mode of its exercise. A control is said to exist if one entity holds not less than 30% of the outstanding shares entitled to vote of a corporation. A presumption of control arises if income or deductions have been arbitrarily shifted.

Controlled transaction means any transaction between two or more members of the same group of controlled parties/related parties.

Independent parties. Two enterprises are independent parties with respect to each other if they are not related/associated parties with respect to each other.

Intangible property, for purposes of allocation, must have value independent of the services of individual persons, and includes items like:

- a. Patents, inventions, formulas, processes, designs, patterns, and other similar items;
- b. Copyrights, literary, musical, or artistic compositions, and other similar items;
- c. Trademarks, trade names, brand names, and other similar items;
- d. Franchises, licenses, contracts, and other similar items;
- e. Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

Multinational enterprise group (MNE group) is a group of related/associated parties with business establishments in two or more countries.

Multinational enterprise (MNE) is a company that is part of an MNE group.

Organization, trade or business refers to an organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation as each is defined under existing laws, irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether it is domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

Transaction includes any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented. A transaction also includes the performance of services (including financial services) for the benefit of, or on behalf of, another party.

True taxable income means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted in the controlled transaction, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with its related party at arm's length.

Uncontrolled transaction means any transaction between two or more parties which are not members of the same group of controlled parties/related parties.

Open market refers to a place or situation where a seller not compelled by any circumstances to sell is willing to sell his property or services to a buyer who is not compelled to buy likewise by any demanding circumstances. In short, it is a place or situation where a willing and knowledgeable buyer can meet a willing and knowledgeable seller.

Dealing at arm's length means relating to a related party as if said related party is an unrelated party.

Arm's length standard refers to the standard or benchmark set applying the results/conditions in a transaction between independent parties.

Transfer pricing guidelines refers to set of rules to be observed/followed in assessing whether the economic value of a transaction is consistent with the arm's length standard.

Advance pricing arrangement (“APA”) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for mentioned transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer, bilateral involving the agreement of two tax administrations and the related parties who are part of the controlled transaction(s), or multilateral involving the agreement of more than two tax administrations and the related parties who are part of the controlled transaction(s), or in short, a multilateral APA is a number of combined bilateral APAs.

Mutual agreement procedure (MAP) is a means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorized by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

SECTION 4. SCOPE AND PURPOSE OF REVIEW. – The purpose of Section 50 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance and evasion of taxes with respect to such transactions. Further, it places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.

Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, escape or evade taxes. Therefore, the authority of the Commissioner to determine true taxable income extends to any case in which, either by inadvertence or design, the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer, in the conduct of its affairs, been dealing at arm’s length with an uncontrolled taxpayer.

Thus, the Commissioner may allocate income, deductions, credits, allowances, basis, or any other items or elements affecting taxable income. Such allocation may take the form of an increase or decrease in any relevant amount.

SECTION 5. LIMITATIONS TO ALLOCATION. – Unless the structure adopted by the controlled taxpayer lacks economic substance, the Commissioner shall evaluate the results of a transaction as actually structured by the taxpayer.

Under the following situations, however, transactions may be recharacterized: (1) the economic substance differs from the form; and (2) the substance and the form of the transaction are the same but the arrangements

made in relation to the transaction, viewed in totality, economically/commercially do not make sense.

SECTION 6. ARM'S LENGTH STANDARD. – In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results/conditions of the transaction are consistent with the results/conditions that would have been realized, made or imposed if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). For this purpose, data based on the results of transactions between unrelated parties provide the most objective basis for determining whether the results of a controlled transaction are at arm's length. The two primary factors to be considered in this respect are the degree of comparability (i.e., sufficient similarity) between the controlled transaction and/or taxpayer and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis.

SECTION 7. COMPARABILITY ANALYSIS –Features of comparability analysis as well as reasons for doing it are discussed as follows:

7.1. Reason for examining comparability

7.1.1. Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. In determining the degree of comparability, including what adjustments are necessary to establish it, an understanding of how unrelated companies evaluate potential transactions is required. Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive. For example, one enterprise is unlikely to accept a price offered for its product by an

independent enterprise if it knows that other potential customers are willing to pay more under similar conditions. This point is relevant to the question of comparability, since independent enterprises would generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk or other comparability factors discussed below) when valuing those options. Therefore, when making the comparisons entailed by application of the arm's length principle, tax administrations should also take these differences into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

7.1.2 All methods that apply the arm's length principle can be tied to the concept that independent enterprises consider the options available to them and in comparing one option to another they consider any differences between the options that would significantly affect their value. For instance, before purchasing a product at a given price, independent enterprises normally would be expected to consider whether they could buy the same product at a lower price from another party. Therefore, as discussed, the comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to, had they resorted directly to a market alternative to the controlled transaction. However, the method becomes a less reliable substitute for arm's length dealings if not all the characteristics of these uncontrolled transactions that significantly affect the price charged between independent enterprises are comparable. Similarly, the resale price and cost plus methods compare the gross profit margins earned in the controlled transaction to gross profit margins earned in similar uncontrolled transactions. The comparison provides an estimate of the gross profit margin one of the parties could have earned had it performed the same functions for independent enterprises and therefore provides an estimate of the payment that party would have demanded, and the other party would have been willing to pay, at arm's length for performing those functions. Other methods are based on comparisons of profit rates or margins between independent and associated enterprises as a means to estimate the profits

that one or both of the associated enterprises could have earned had they dealt solely with independent enterprises, and therefore the payment those enterprises would have demanded at arm's length to compensate them for using their resources in the controlled transaction. In all cases, adjustments must be made to account for differences between the controlled and uncontrolled situations that would significantly affect the price charged or return/profit margin required by independent enterprises. Therefore, in no event can unadjusted industry average returns themselves establish arm's length conditions.

7.1.3. As noted above, in making these comparisons, material differences between the compared transactions or enterprises should be taken into account. In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm's length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length dealings. Attributes that may be important include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties.

7.1.4 The extent to which each of these factors matters in establishing comparability will depend upon the nature of the controlled transaction and the pricing method adopted.

7.2 .Factors determining comparability

7.2.1. Characteristics of property or services

Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions. In general, similarity in the characteristics of the property or services transferred will matter most when comparing prices of controlled and

uncontrolled transactions and less when comparing profit margins. Characteristics that may be important to consider include the following: in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (e.g. licensing or sale), the type of property (e.g. patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property.

7.2.2. Functional analysis

7.2.2.1. In dealings between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, comparison of the functions taken on by the parties is necessary. This comparison is based on a functional analysis, which seeks to identify and to compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises. For this purpose, particular attention should be paid to the structure and organization of the group. It will also be relevant to determine in what juridical capacity the taxpayer performs its functions.

7.2.2.2. The functions that taxpayers and tax administrations might need to identify and compare include, e.g., design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing, and management. The principal functions performed by the party under the examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

7.2.2.3. It may also be relevant and useful in identifying and comparing the functions performed to consider the assets that are employed or to be employed. This analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, etc. and the nature of the assets used, such as the age, market value, location, property right protections available, etc.

7.2.3 Contractual terms

7.2.3.1 In arm's length dealings, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. As such, an analysis of contractual terms should be a part of the functional analysis discussed above. The terms of a transaction may also be found in correspondence/communications between the parties other than a written contract. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.

7.2.3.2 In dealings between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conform to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.

7.2.4 Economic circumstances

Arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate are comparable; and that differences

do not have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets taking account of available substitute goods or services. Economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labor, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth.

7.2.5. Business strategies

7.2.5.1. Business strategies must also be examined in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labor laws, and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises. It will also be relevant to consider whether business strategies have been devised by the MNE group or by a member of the group acting separately and the nature and extent of the involvement of other members of the MNE group necessary for the purpose of implementing the business strategy.

7.2.5.2. Business strategies also could include market penetration schemes. A taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Furthermore, a taxpayer seeking to enter a new market or expand (or defend) its market share might temporarily incur higher costs (e.g. due to start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.

SECTION 8. ARM'S LENGTH PRICING METHODOLOGIES. – In determining the arm's length standard/price, the *'traditional transaction methods'* may be used namely, the comparable uncontrolled price method, resale price method, and the cost plus method. When these traditional transaction methods cannot be reliably applied or cannot be applied at all, the *'transactional profit methods'* which are the profit split method and transactional net margin method, in the singular alternative, may be used.

The interplay of the methods is illustrated in the following example. Consider two members of an MNE group that have the following profit and loss statements:

Manufacturer Co.

Sales to Distributor Co.	10,000	(transfer price)
Less manufacturing costs	<u>(5,000)</u>	
Gross profit	5,000	
Less Operating expenses	<u>(3,000)</u>	
Net Profit	<u>2,000</u>	

Distributor Co.

Sales to third parties	20,000
Less Purchases from Manufacturer Co.	<u>(10,000)</u>
Gross Profit	10,000
Operating expenses	<u>(4,000)</u>
Net Profit	<u>6,000</u>

The **comparable uncontrolled price (CUP) method** (see Section 8.1) focuses directly on the price of the property or services transferred between parties to a transaction. The price charged between independent parties forms the basis for determining the arm's length price under the CUP method.

Thus, in the example, the issue to be determined is whether the transfer price adopted between Manufacturer Co. and Distributor Co. (10,000) is consistent with the price adopted by independent firms for a comparable product in comparable circumstances.

The **resale price method** (see Section 8.2) focuses on the gross margin obtained by the distributor. This margin represents the amount from which a reseller would seek to cover its selling and other operating expenses and make an appropriate profit in relation to its functions performed, assets used, and risks assumed. The margin obtained by independent distributors is used as the basis for determining the appropriate margin for the member of the MNE.

Thus, in the example, the issue to be determined is whether the gross margin of 50% obtained by Distributor Co. ($10,000 / 20,000$) is consistent with the gross margin earned by independent distributors performing comparable functions to those of the MNE.

The **cost plus method** (see Section 8.3) focuses on the gross margin obtained by the manufacturer. The arm's length price is determined by adding a margin to the costs incurred by the member of the MNE to determine an appropriate profit in relation to its functions performed, assets used, risks assumed, and the market conditions. This margin is determined by reference to the margins earned by comparable independent manufacturers performing comparable functions.

Thus, in the example, the issue to be determined is whether the gross margin of 100% obtained by Manufacturer Co. [$(10,000 - 5,000) / 5,000$] is consistent with the gross margin earned by independent manufacturers performing comparable functions to those of the MNE.

The **profit split method** (see Section 8.4) starts by identifying the combined profit in a controlled transaction to be split between the involved associated enterprises. That profit is then split between the associated enterprises based upon an economically valid basis approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

Thus, in the example, the combined gross profit of 15,000 (20,000 sales less 5,000 manufacturing costs) is to be split on the basis of the relative contribution of each member to the gross profit, or the combined net profit of 8,000 is to be split on the basis of the value of the contribution of each member to the combined net profit.

The **transactional net margin method (TNMM)** (see Section 8.5) is a method that examines the net profit margin realized by a taxpayer from a controlled transaction relative to an appropriate base. Possible bases include assets, sales, total cost and expense.

In the example, the distributor may use the ratio of net profit to sales, which is 30% ($6,000 / 20,000$). The issue to be determined is whether this margin is consistent with the margin earned by independent distributors performing comparable functions to those of the MNE.

8.1.COMPARABLE UNCONTROLLED PRICE (CUP) METHOD. – The CUP method evaluates whether the amount charged in a controlled transaction is at arm's length by reference to the amount charged in a comparable uncontrolled transaction in comparable circumstances. It is

the most direct way of ascertaining an arm's length price for the transaction between related parties by the direct price comparison with the transaction involving a similar product between independent parties. It shall be used only if comparable products/services are available or if reasonably accurate/reliable adjustments can be made to eliminate the material effects of such differences.

The comparable uncontrolled price of the seller in the controlled transaction, ideally, shall be determined by reference to the sale price that the same seller charges on items sold in comparable uncontrolled transactions due to the fact that similar characteristics are more likely found among sales of products/services by the same supplier, than among sales by other suppliers. In the absence of such transactions, the comparable uncontrolled price shall be determined by reference to the sale price charged by an independent enterprise in comparable uncontrolled transactions.

8.1.1. For purposes of the CUP method, an uncontrolled transaction is comparable to a controlled transaction if any one of the following conditions is met:

8.1.1.1 None of the differences, if any, between the transactions being compared or between the parties undertaking these transactions could materially affect the price in the open market; or

8.1.1.2 Reasonably accurate adjustments can be made to eliminate the material effects of such differences.

8.1.2. The use of the CUP method to determine transfer price entails identification of all the differences between the product or service of the controlled taxpayer and that of the independent party. If these differences have a material effect on the price, adjustment of the price of products sold/services rendered by the independent party to reflect these differences shall be made to arrive at the arm's length price. A comparability analysis under the CUP method shall take into account the following:

8.1.2.1 Product characteristics such as physical features and quality;

8.1.2.2 If the product is in the form of services, the nature and extent of such services provided;

- 8.1.2.3 Whether the goods sold are compared at the same points in the supply or production chain;
- 8.1.2.4 Product differentiation in the form of patented features such as trademarks, design, etc.;
- 8.1.2.5 Volume of sales if it has an effect on price;
- 8.1.2.6 Timing of sale if it is affected by seasonal fluctuations or other changes in market conditions;
- 8.1.2.7 Whether cost of transport, packaging, marketing, advertising, and warranty are included in the deal; and
- 8.1.2.8 Whether the products are sold in places where the economic conditions are the same.
- 8.1.2.9 Whether a business strategy is adopted in the controlled transaction that would produce material difference on the price of the controlled transaction as against the price in an uncontrolled transaction

8.1.3. The CUP method compares the price charged for properties or services transferred in a related party transaction to the price charged for properties or services transferred in an independent transaction in comparable circumstances. Any difference in the two prices may suggest that the related parties are not dealing on an arm's length basis, and that the price in the related party transaction may need to be substituted with the price in the independent transaction.

8.1.4. By comparing the price or value of the transactions, the CUP method employs the most direct assessment of whether the arm's length principle is complied with. As it is the most direct method, it should, in theory, be preferred to the other methods.

8.1.5. However, the direct comparison in the CUP method also means that it is reliable only if there is a high level of comparability between the transaction in question and the independent transaction, or where reasonably accurate adjustments can be made to eliminate the effects of the material differences. This is because the price or value of a property or service is very sensitive to differing characteristics, functions performed and market conditions, etc.

8.1.6. In practice, the CUP method is usually most suitable for evaluating transactions involving products/services with very similar characteristics (in terms of type, physical features, quality and quantity transacted, etc) and undertaken in similar market or economic conditions, such as widely traded commodities. In such cases, where there is little room for product differentiation, the similarities in the characteristics of product and market or economic conditions are much more significant than the comparability of functions performed, risks assumed and assets used by the entities.

8.1.7. In summary, where it is possible to locate comparable independent party transactions, the CUP method should be adopted as it provides the most direct evidence of an arm's length price. However, taxpayers must bear in mind that the CUP method requires a relatively high level of comparability to produce reliable results. Hence, if reasonably accurate adjustments for differences in comparability cannot be made, it is necessary to select a less direct method instead.

8.1.8. BIR encourages taxpayers to look out for both internal and external comparable transactions and then identify the most suitable ones to be used in their transfer pricing analyses.

8.1.9. Example on the Application of the CUP Method. - An uncontrolled taxpayer sells unbranded Colombian coffee beans of a similar type, quality, and quantity as those sold between two controlled taxpayers. The controlled and uncontrolled transactions occur at about the same time, at the same stage in the production/distribution chain, and under similar conditions. If the only available uncontrolled transaction involved unbranded Brazilian coffee beans, it would be appropriate to inquire whether the difference in the coffee beans has a material effect on the price. For example, it could be asked whether the source of coffee beans commands a premium or requires a discount generally in the open market. Such information may be obtainable from commodity markets or may be deduced from dealer prices. If this difference does have a material effect on price, some adjustments would be appropriate. If a reasonably accurate adjustment cannot be made, the reliability of the CUP method would be reduced, and it might be necessary to use other less direct method instead.

8.1.10. Another simplified example on the CUP Method (Using External CUP)

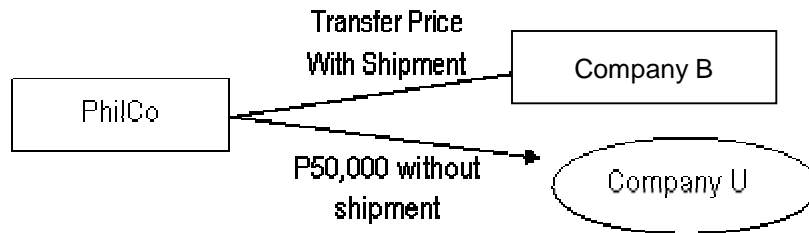
PhilCo, a Philippine enterprise, sells a commodity product to its overseas subsidiary, Company A, which is located in country A. This commodity product is widely and competitively traded in country A and the price of the commodity at any point in time is easily available. In this case, the market

price would be the CUP to determine if the transfer price between PhilCo and Company A is at arm's length.

The market price adopted in the above example is commonly termed as "external CUP". Many taxpayers tend to rely on such external data in their attempts to locate comparable independent transactions. In practice, many tax administrations have found internal comparable transactions (commonly termed as "internal CUP") to be also useful and reliable in establishing the arm's length price. An internal comparable may arise where the taxpayer or another member of the group buys or sells the particular product, in similar quantities and under similar terms to independent parties in similar markets.

8.1.11. Another Simplified Example on the CUP Method (Using Internal CUP)

PhilCo, a Philippine enterprise, sells only one type of computer disk drive. The disk drives are sold to 2 entities: PhilCo's overseas subsidiary, Company B and a local unrelated company, Company U. Under the agreement between PhilCo and Company B, PhilCo will ship the hard disks to Country B where Company B is located on a CIF basis. On the other hand, Company U takes possession of the hard disks at PhilCo's factory.



Assuming that the volume of PhilCo's disk drive sales to both parties are similar in any one particular period, the CUP for the disk drives sold to Company B could be computed as follows:

Price of disk drives sold to Company U (per container of goods)	P50,000
Add : Adjustment for insurance and freight	P 400
Transfer price (per container of goods) based on CUP	<u>P50,400</u>
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8.2. RESALE PRICE METHOD. – The resale price method is applied where a product that has been purchased from a related party is resold to an independent party. Essentially, it seeks to value the functions performed by the reseller of a product. The resale price method evaluates

whether the amount charged in a controlled transaction is at arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. This method is generally appropriate where the final transaction is made with an independent party. The usefulness of the method largely depends on how much added value or alteration the reseller has done on the product before it is resold, or the time lapse between purchase and onward sale. Thus, the resale price method is most appropriate in a situation where the reseller adds relatively little value to the properties. The greater the value added to the properties by the reseller, for example, through complicated processing or assembly with other products or, the longer the time lapse – to the extent that market conditions might have changed – before it is resold or, when the reseller contributes substantially to the creation or maintenance of an intangible property that is attached to the product, such as trademarks or tradenames, the more difficult it is to use the resale price method to arrive at the arm's length price.

The starting point in the resale price method is the price (the resale price) at which a product that has been purchased in a controlled sale is then resold to an independent third party (uncontrolled resale). This price (the resale price) is then reduced by an appropriate gross margin (the resale price margin) representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of functions performed (taking into account assets used and risks assumed), make an appropriate profit. An arm's length price for the original transfer of property between the associated enterprises (controlled transaction) is obtained after subtracting the gross margin (resale price margin) from the resale price, and adjusting for other costs associated with the purchase of the product, such as customs duties.

As gross profit margins represent the gross compensation (after cost of sales) for specific functions performed, assets used and risks assumed, product differences are less critical than under the CUP method. Therefore, where the related and independent party transactions are comparable in all aspects except for the product itself, the resale price method might produce a more reliable measure of arm's length conditions than the CUP method. Nonetheless, it can be expected that the more comparable the products, the more likely it is that the resale price method will produce better results.

The resale price margin of the reseller in the controlled transaction, ideally, shall be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions due to the fact that similar characteristics are more likely found among sales of products by the same supplier, than among sales by other suppliers. In the absence of such transactions, the

resale price margin shall be determined by reference to the resale price margin earned by an independent enterprise in comparable uncontrolled transactions.

8.2.1. For purposes of the resale price method, an uncontrolled transaction is comparable to a controlled transaction if any one of the following conditions is met:

8.2.1.1 None of the differences, if any, between the transactions being compared or between the parties undertaking these transactions could materially affect the resale price margin in the open market; or

8.2.1.2 Reasonably accurate adjustments can be made to eliminate the material effects of such differences.

8.2.2. The following are factors which may influence the resale price margin and other considerations when performing a comparability analysis for purposes of the resale price method:

8.2.2.1. Functions or level of activities performed by the reseller and the risks undertaken, e.g., whether the reseller is merely a forwarding agent or, a distributor who assumes full responsibility for marketing and advertising the product by risking its own resources in these activities;

8.2.2.2. Whether similar assets are employed in the controlled and uncontrolled transactions, e.g., a developed distribution network;

8.2.2.3. Although broader product differences are allowed as compared to the CUP method, product similarities are still significant to some extent particularly when there is a high value or unique intangible attached to the product;

8.2.2.4. If the resale price margin used is that of an independent enterprise in a comparable transaction, differences in the way business is managed may have an impact on profitability;

8.2.2.5. The time lapse between original purchase and resale of the product as a longer time lapse may give rise to changes in the market, exchange rates, costs, etc.;

- 8.2.2.6. Whether the reseller is given exclusive rights to resell the products;
- 8.2.2.7. Differences in accounting practices where adjustments must be made to ensure that the components of costs in arriving at gross margins in the controlled and uncontrolled transactions are the same.
- 8.2.2.8. Whether cost of transport, packaging, marketing, advertising, and warranty are included in the deal; and
- 8.2.2.9. Whether the products are sold in places where the economic conditions are the same.
- 8.2.2.10. Whether a business strategy is adopted in the controlled transaction that would produce material difference on the resale gross margin of the controlled transaction as against the resale gross margin in an uncontrolled transaction.

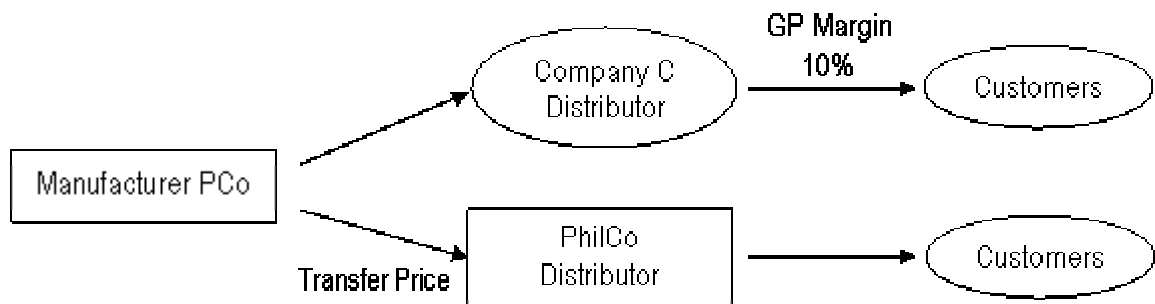
8.2.3 Examples on the application of the resale price method:

- 8.2.3.1** Two distributors sell the same product in the same market under the same brand name. Distributor A offers a warranty while Distributor B offers none. Distributor A is including the warranty as part of a pricing strategy and so sells its product at a higher price resulting in a higher gross profit margin (if the costs of servicing the warranty are not taken into account) than that of Distributor B, which sells at a lower price. The two margins are not comparable until an adjustment is made to account for that difference.
- 8.2.3.2** In the preceding example, assume that a warranty is offered with respect to all products so that the downstream price is uniform. Distributor A performs the warranty function but is, in fact, compensated by the supplier through a lower price. Distributor B does not perform the warranty function which is performed by the supplier (products are sent back to the factory). However, Distributor B's supplier charges B a higher price than is charged to

Distributor A. If Distributor A accounts for the cost of performing the warranty function as a cost of goods sold, then the adjustment in the gross profit margins for the difference is automatic. However, if the warranty expenses are accounted for as operating expenses, there is a distortion in the gross margins which must be corrected.

8.2.4. Another Simplified Example on the Resale Price Method

PhilCo distributes laptop computers in the Philippines for its overseas parent company, PCo. Company C, a Philippine company unrelated to PCo, has also been appointed by PCo to distribute desktop computers for it in Philippines. In this example, it is assumed that the laptop and desktop markets are similar in the Philippines. The main difference between the two distributorship agreements is that PhilCo performs promotional and marketing functions for PCo whereas Company C does not.



The gross profit margin of Company C from the resale of desktops to consumers was found to be 10%.

The arm's length price for the related party transaction is computed as follows:

PhilCo's sales of laptop to unrelated parties	P3,500
Less: Arm's length resale price margin based on Company C's transactions (10% x 3,500)	<u>P 350</u>
	P3,150
Less: Adjustment for marketing costs	<u>P 80</u>
Transfer price (based on resale price method)	P3,070

The above example is based on an internal comparable i.e. PCo's transactions with Company C (an independent party) is used to benchmark the transactions with PhilCo (a related party). The same analysis could be undertaken using external comparables i.e. benchmarking the related party transactions between PCo and PhilCo

against comparable transactions between an independent manufacturer and distributor.

8.3. COST PLUS METHOD. – The cost plus method focuses on the gross mark-up obtained by a supplier who transfers property or provides services to a related purchaser. Essentially, the method attempts to value the functions performed by the supplier of the property or services. The cost plus method is most useful where semi-finished goods are sold between related parties or where the related party transaction involves the provision of services.

The cost plus method indirectly measures whether the price for the property or service in the controlled transaction is an arm's length price by assessing whether the mark-up on the costs incurred by the supplier of the property or service in the controlled transaction meets the arm's length standard. This method is often useful in cases involving the manufacture, assembly, or other production of goods that are sold to related parties or where controlled transaction involves the provision of intra-group services.

The starting point in a cost plus method is the cost incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate mark-up is added to this cost to find the price that the supplier should be charging the buyer. The appropriate mark-up, ideally, shall be established by reference to the mark-up earned by the same supplier from comparable uncontrolled transactions, due to the fact that similar characteristics are more likely found among sales of products/services by the same supplier, than among sales by other suppliers. If no such transactions exist, the appropriate mark-up may be determined based on comparable transactions by independent parties. If there are material differences between the controlled and uncontrolled transaction that could affect the gross profit mark-up, appropriate adjustments must be made on the gross profit mark-up earned in the uncontrolled transaction.

The cost base used in determining costs and the accounting policies should be consistent and comparable between the controlled and uncontrolled transaction, and over time in relation to the particular enterprise. The costs referred to in the cost plus method are the aggregation of direct and indirect costs of production.

8.3.1. For purposes of the cost plus method, an uncontrolled transaction is comparable to a controlled transaction if any one of the following conditions is met:

8.3.1.1. None of the differences, if any, between the transactions being compared or between the parties undertaking these transactions could materially affect the cost plus mark-up in the open market; or

8.3.1.2. Reasonably accurate adjustments can be made to eliminate the material effects of such differences.

8.3.2. Comparability when applying the cost plus method should take into account the similarity of functions performed, assets used and risks assumed, contractual terms, market conditions and business strategies as well as any adjustments made to account for the effects of any differences in the aforementioned factors between the controlled and uncontrolled transactions.

A comparability analysis under the cost plus method shall take into account the following:

8.3.2.1. Functions or level of activities performed by the seller and the risks undertaken;

8.3.2.2. Whether similar assets are employed in the controlled and uncontrolled transactions;

8.3.2.3 Although broader product differences are allowed as compared to the CUP method, product similarities are still significant to some extent;

8.3.2.4. If the gross margin used is that of an independent enterprise in a comparable transaction, differences in the way business is managed may have an impact on profitability;

8.3.2.5. Differences in accounting practices where adjustments must be made to ensure that the components of costs in arriving at gross margins in the controlled and uncontrolled transactions are the same.

8.3.2.6. Whether cost of transport, packaging, marketing, advertising, and warranty are included in the deal; and

8.3.2.7. Whether the products are sold in places where the economic conditions are the same.

8.3.2.8. Whether a business strategy is adopted in the controlled transaction that would produce material difference on the cost plus mark-up of the

controlled transaction as against the cost plus mark-up in an uncontrolled transaction.

As in the resale price method, fewer adjustments may be necessary to account for product differences under the cost plus method than the CUP method, and it may be appropriate to focus on other factors of comparability (such as the functions performed and economic circumstances). Where the related party and independent party transactions are not comparable in all aspects and the differences have a material effect on the margin, taxpayers are expected to make adjustments to eliminate the effects of these differences.

8.3.3. Example on the application of the cost plus method. – C is a domestic manufacturer of timing mechanisms for mass-market clocks. C sells this product to its foreign subsidiary D. C earns a 5 percent gross profit mark up with respect to its manufacturing operation. X, Y, and Z are unrelated domestic manufacturers of timing mechanisms for mass-market watches. X, Y, and Z sell to unrelated foreign purchasers. X, Y, and Z earn gross profit mark ups with respect to their manufacturing operations that range from 3 to 5 percent. C accounts for supervisory, general and administrative costs as operating expenses, and thus these costs are not reflected in cost of goods sold. The gross profit mark ups of X, Y, and Z, however, reflect supervisory, general, and administrative costs as part of costs of goods sold. Therefore, the gross profit mark ups of X, Y, and Z must be adjusted to provide accounting consistency. After the adjustment, the gross profit mark-ups of X, Y, Z become the gross profit mark-ups against which C's gross profit mark-up shall be benchmarked, which means that C's gross profit mark-up must fall within the range of gross profit mark-ups of X, Y and Z.

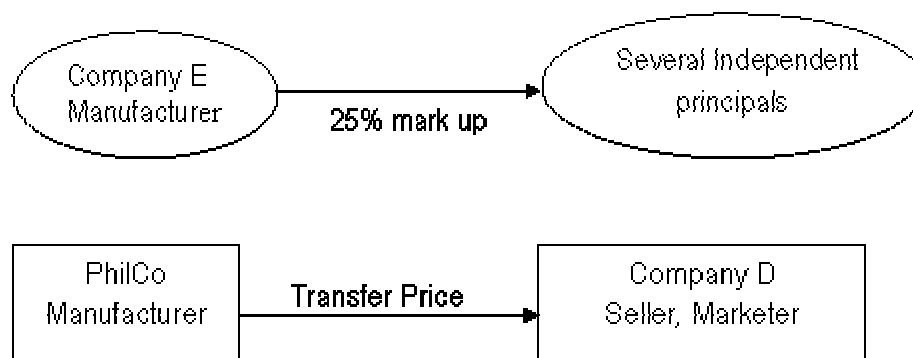
8.3.4. Another Simplified Example on the Cost Plus Method

PhilCo is a domestic manufacturer of a specialized drug for its overseas associated company, Company D. The MNE group to which PhilCo and Company D both belong is the inventor of the drug and the only producer in the world.

Under the agreement, Company D provides all the know-how used in the manufacturing of the drug and undertakes to acquire a fixed output from PhilCo every month. Payment is to be made based on the costs incurred by PhilCo, along with a mark-up to reflect a profit element for PhilCo. Based on PhilCo's financial statements, the cost incurred to manufacture one unit of the drug is P70.

PhilCo essentially performs the role of a contract manufacturer. An unrelated Philippine manufacturing company in the pharmaceutical industry that manufactures a different drug, Company E, has been

identified as a potential comparable company. Company E charges an average mark-up of 25% for providing similar contract manufacturing services to several other independent companies.



The transfer price for the related party transaction is computed as follows:

Direct and indirect cost incurred by PhilCo to manufacture one unit of drug	P70.00
Arm's length mark up (25% x 70.00)	<u>P17.50</u>
Transfer price (based on the cost plus method)	<u>P87.50</u>

The above example is based on an external comparable i.e. PhilCo's transactions with Company D (a related party) are benchmarked against the transactions between Company E and independent parties. The same analysis could be undertaken using internal comparables e.g. benchmarking the related party transactions between PhilCo and Company D against comparable transactions between PhilCo and an independent party.

8.4 PROFIT SPLIT METHOD. – The profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.

This method provides an alternative in cases where no comparable transactions between independent parties can be identified. This is true normally in a situation where transactions are very interrelated that they cannot be evaluated separately, or in the situation involving a unique intangible. The method is based on the concept that profits earned in a controlled transaction should be equitably divided among related parties involved in the transaction(s) on an economically valid basis that approximates the division of profits that would have been anticipated and

reflected in an agreement made at arm's length. Under similar circumstances, independent parties might decide to set up a form of partnership and agree to a form of profit split.

Generally, the profit to be split is the operating profit, although occasionally, it may be appropriate to carry out a split of the gross profit and then deduct the expenses incurred by or attributable to each relevant party.

The allocation of profit or loss under the profit split method shall be made in accordance with the following approaches:

8.4.1. Residual Profit Split Approach. – The combined profits from the controlled transactions under examination are split in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily this basic return would be determined by reference to the market return achieved for similar types of transactions by independent parties. Thus, the basic return would generally account for the value, with reference to comparable independent market data, of the contribution or functions performed by each party and not account for the return that would be generated by any unique and valuable assets possessed by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent parties, e.g., taking into consideration the value of unique assets used by the parties, usually intangible assets. The remaining profit which is attributable to such unique assets is allocated between the parties based on the relative contributions of the parties to the creation of such assets, taking into consideration how independent parties would have divided such residual profits in similar circumstances.

8.4.1.1 Example on the Profit Split Method (Residual Analysis Approach)

PhilCo is a Philippine manufacturing and sales company for telecommunication products. It developed an original microprocessor and holds the patent for the manufacturing technology. Company F, an overseas subsidiary of PhilCo, develops and manufactures mobile equipment using the new microprocessor as well as technology developed by itself. Company F is the only manufacturer licensed by PhilCo to use the new microprocessor. PhilCo purchases all of the mobile equipment manufactured by Company F and sells them to third parties.

Both companies contribute to the success of the mobile equipment through their design of the microprocessor and the equipment. As the nature of the products are very advanced and unique, the group is unable to locate any comparable with similar intangible assets. Therefore, neither the traditional methods nor the TNMM are appropriate in this case.

Nevertheless, the group is able to obtain reliable data on handphone contract manufacturers and equipment wholesalers without unique intangible property in the telecommunication industry. The manufacturers earn a mark-up of 10% while the wholesalers derive a 25% margin on sales.

PhilCo's and Company F's respective share of profit is determined in 2 steps using the profit split method (residual analysis approach).

- Step 1 – Determining the basic return

The simplified accounts of PhilCo and Company F are shown below:

	Company F (₱)	PhilCo (₱)
Sales	100	125
Cost of Goods Sold	(60)	(100)
Gross Margin	40	25
Sales, General & Admin	(5)	(15)
Operating Margin	35	10

The total operating profit for the group is P45.

Company F

Cost of goods sold	P 60
Cost mark-up of contract manufacturer (10% x 60)	<u>6</u>
Transfer price based on comparables (without intangibles)	P 66
	=====

PhilCo

Sales to third party customers	P125
Resale margin of wholesalers comparables (without intangibles)	<u>25%</u>
Resale margin (or gross margin)	P31.25
	=====

Computation of basic return based on comparables (without intangibles)

	Company F (₱)	PhilCo (₱)
Sales	66	
Cost of Goods Sold	(60)	

Gross Margin	6	31.25
Sales, General & Admin	(5)	(15)
Routine Operating Margin	1	16.25

The total operating margin of the group is P17.25.

- Step 2: Dividing the residual profit

The residual profit of the group is = ₱ 45 – ₱ 17.25 = ₱ 27.75

On further study of the two companies, two particular expense items, R&D expenses and marketing expenses, are identified as the key intangibles critical to the success of the mobile equipment. The R&D expenses and marketing expenses incurred by each company are:

PhilCo	₱ 12 (80%)
Company F	₱ 3 (20%)

Assuming that the R&D and marketing expenses are equally significant in contributing to the residual profits, based on the proportionate expenses incurred:

PhilCo's share of residual profit (80% x 27.75)	₱ 22.20
	=====
Company F's share of residual profit (20% x 27.75)	₱ 5.55
	=====

Therefore, the adjusted operating profit of

PhilCo is = ₱ 22.20 + ₱ 16.25 = ₱ 38.45, and

Company F is = ₱ 5.55 + ₱ 1 = ₱ 6.55.

The adjusted tax accounts are as follows:

	Company F (₱)	PhilCo (₱)
Sales	71.55	125
Cost of Goods Sold	(60)	(71.55)
Gross Margin	11.55	53.45
Sales, General & Admin	(5)	(15)
Operating Margin	6.55	38.45

Hence, the transfer price determined using the profit split method (residual analysis approach) should be ₱ 71.55.

8.4.2. Contribution Profit Split Approach. – The combined profits, which are the total profits from the controlled transactions

under examination, are divided between the associated enterprises in a single stage based upon the parties' relative contribution to the profit or the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.

8.5. TRANSACTIONAL NET MARGIN METHOD (TNMM). – The TNMM operates in a manner similar to the cost plus and resale price methods in the sense that it uses the margin approach. This method examines the net profit margin relative to an appropriate base such as costs, sales or assets attained by the member of a group of controlled taxpayers from a controlled transaction. As with the cost plus or resale price methods, this margin shall, ideally, be derived from comparable uncontrolled transactions between the same member of the group and independent parties. If there are no comparable uncontrolled transactions involving the said member of the group, reference shall be made to the net profit margin that would have been earned in comparable transactions by independent parties.

The TNMM compares the net profit margins attained by an entity from a related party transaction to those attained by the same entity in uncontrolled transactions or, by comparable independent entities involved in similar transactions, relative to some appropriate base such as costs, sales, or assets.

Being a transactional profit method that is typically applied to only one of the parties involved in the transaction, the TNMM is closely aligned to the resale price and cost plus methods

This similarity means that this method requires a level of comparability similar to that required for the application of the two traditional transaction methods (the resale price method, and the cost plus method).

The primary difference between the TNMM and the resale price or cost plus method is that the former focuses on the net margin instead of the gross margin of a transaction. One of the weaknesses of using net margin as the basis for comparison is that it can be influenced by many factors that either do not have an effect, or have a less substantial or direct effect, on price or gross margins. Examples of such factors include the efficiency of plant and machinery used, management and personnel

capabilities, competitive position, etc. Unless reliable and accurate adjustments can be made to account for these differences, the TNMM may not produce reliable measures of the arm's length net margins.

8.5.1. Example on the Transactional Net Margin Method (TNMM)

PhilCo is a Philippine manufacturer of dishwashers. All PhilCo's dishwashers are sold to an overseas associated enterprise, Company G, and bears Company G's brand. Company G, a household electrical appliances brand name, sells only dishwashers manufactured by PhilCo.

The CUP method is not applied in this case because no reliable adjustments can be made to account for differences with similar products in the market. After the appropriate functional analysis, PhilCo was able to identify a Philippine manufacturer of home electrical appliances, Company H, as a suitable comparable company. However, Company H performs warranty functions for its independent wholesalers, whereas PhilCo does not. Company H realizes a net mark up (i.e. operating margin) of 10%.

As the costs pertaining to the warranty functions cannot be separately identified in Company H's accounts and no reliable adjustments can be made to account for the difference in the functions, it may be more reliable to examine the net margins in this case. The transfer price for PhilCo's sale of dishwashers to Company G is computed using the TNMM as follows:

PhilCo's cost of goods sold	P5,000
PhilCo's operating expenses	<u>P1,500</u>
Total costs	P6,500
Add: Net mark up (10% x 6,500)	P 650
Transfer price based on TNMM	P7,150
	=====

SECTION 9. BEST TRANSFER PRICING METHOD. – In general, the method that provides the most reliable measure of an arm's length result shall be used. The traditional transaction methods provide for a more direct comparison with independent party transactions and hence would be superior to the transactional profit methods. The *traditional transaction methods* are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. As a result, *traditional transaction methods* are preferable to other methods. However, neither the BIR nor the taxpayer is held to the hierarchy of methods specified in Section 8 of these Regulations. In

practice, however, the reliability of the results produced by any method would be crucially affected by the availability and quality of data as well as the accuracy with which adjustments to achieve comparability can be made. Hence, BIR does not have a specific preference for any one method. Instead, the method that produce the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments, should be chosen. In deciding the most appropriate method, the following shall be considered:

- a) the degree of actual comparability when making comparisons of transactions between related parties with transactions between independent parties;
- b) the completeness and accuracy of data in respect of the uncontrolled transaction;
- c) the reliability of any assumption(s) made; and
- d) the degree of reliability in which the adjustments are effected.

In all instances, related parties are required to explain why a specific method is selected or used in recording related-party transactions.

SECTION 10. THE APPLICATION OF ADVANCE PRICING ARRANGEMENTS IN AVOIDING AND RESOLVING TRANSFER PRICING DISPUTES. –Advance pricing arrangements (APA) could be applied to minimize transfer pricing disputes and to help resolve them when they do arise between taxpayers and the BIR, and between the BIR and tax administrations of other countries. Such disputes may arise even if there is conscientious effort to apply the arm's length principle. It is possible that taxpayers, the BIR and other concerned tax administrations may reach different determinations of the arm's length conditions for the controlled transactions under examination given the complexity of some transfer pricing issues and the difficulties in interpreting and evaluating the circumstances of individual cases.

10.1. HOW INITIATED. – An APA shall formally be initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and the BIR alone or with other tax administrations. APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. They may be most useful when traditional mechanisms fail or are difficult to apply.

Where the BIR and the taxpayer in this jurisdiction establish an arrangement without the involvement of other interested tax administrations (unilateral APA), the competent authorities of other interested jurisdictions shall be informed about the procedure as early as possible to determine whether they are willing and able to consider a bilateral arrangement.

10.2. PARTICIPATION OF ASSOCIATED ENTERPRISES. –

Associated enterprises shall be allowed to participate in the process of obtaining an APA, by presenting the case to and negotiating with the BIR, providing necessary information, and reaching agreement on the transfer pricing issues. The cooperation of the associated enterprises is vital to a successful APA negotiation. The associated enterprises shall be expected to provide the tax administrations with the methodology for determining arm's length standard that they consider most reasonable under the particular facts and circumstances. The associated enterprises shall also submit documentation supporting the reasonableness of their proposal, which would include, for example, data relating to the industry, markets, and countries to be covered by the agreement. In addition, the associated enterprises shall identify uncontrolled transactions that are comparable or similar to the controlled transactions between associated enterprises in terms of the economic circumstances and other factors of comparability.

10.3. COVERAGE. –

An APA may cover all of the transfer pricing issues of a taxpayer (as is preferred by some countries) or may provide a flexibility to the taxpayer to limit the APA request to specified affiliates and intercompany transactions. An APA shall apply to prospective years and transactions and the actual term shall depend on the industry, products or transactions involved. The associated enterprises shall limit their request to specified prospective tax years, not beyond three (3) years from the date of conclusion of the APA, subject to renewal if things or situations do not change. An APA can provide an opportunity to apply the agreed transfer pricing methodology to resolve similar transfer pricing issues in open prior years. However, this application shall require the agreement of the BIR, the taxpayer, and, where appropriate, the treaty partner.

10.4. MONITORING OF COMPLIANCE WITH THE APA. –

A taxpayer that has entered into an APA shall file annual reports demonstrating the extent of its compliance with the terms and conditions of the APA and that critical assumptions remain relevant. The BIR shall continue to examine the taxpayer as part of the

regular audit cycle but without reevaluating the methodology. Instead, the BIR shall limit the examination of the transfer pricing to verifying the initial data relevant to the APA proposal and determining whether or not the taxpayer has complied with the terms and conditions of the APA. With regards to transfer pricing, the BIR shall also examine the reliability and accuracy of the representations in the APA and the annual reports, and the accuracy and consistency of how the particular methodology has been applied. All other issues not associated with the APA fall under regular audit jurisdiction.

10.5. CONCLUSION OF THE APA PROCESS. – At the conclusion of the APA process, the BIR shall provide confirmation to the associated enterprises in this jurisdiction that no transfer pricing adjustment will be made (regarding the issues covered in the agreement) as long as the taxpayer follows the terms of the arrangements. The APA shall also contain a provision providing for possible revision or cancellation of the agreement for future years when business operations change significantly, or when uncontrolled economic circumstances critically affect the reliability of the methodology in a manner that independent enterprises would consider significant for purposes of their decision on transaction with transfer pricing issue.

10.6 CANCELLATION OF APA. – An APA shall be subject to cancellation, even retroactively, in the case of fraud or misrepresentation of information during an APA negotiation, or when a taxpayer fails to comply with the terms and conditions of an APA. Where an APA is proposed to be cancelled or revoked, the BIR proposing the action shall notify the taxpayer and the other tax administrations of its intention and of the reasons for such action.

10.7 IMPLEMENTATION OF APA PROCESS- The BIR shall only start accepting application for APA after the release of the complete set of procedures in processing “Application for APA”

SECTION 11. GENERAL RULES IN THE DETERMINATION OF TAXABLE INCOME IN SPECIFIC SITUATIONS. – The following general rules shall apply with respect to the following situations:

11.1. LOANS OR ADVANCES. - Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest or charges interest at a rate which is not equal to an arm’s length rate of interest with respect to such loan or advances, the Commissioner may make appropriate

adjustment to reflect an arm's length rate of interest for the use of such loan or advance.

An arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors shall be considered, including the principal 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 between unrelated parties.

11.2. PERFORMANCE OF SERVICE FOR ANOTHER. – Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge, the Commissioner may make appropriate adjustment to reflect an arm's length charge for such services.

An arm's length charge for services rendered shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts.

Adjustments and allocations may be made to reflect arm's length charges with respect to services undertaken for the joint benefit of the members of a group of controlled entities, as well as with respect to services performed by one member of the group exclusively for the benefit of another member of the group. Any allocations made shall be consistent with the relative benefits intended from the services, based upon the facts known at the time the services were rendered, and shall be made even if the potential benefits anticipated are not realized. No allocations shall be made if the probable benefits to the other members were so indirect or remote that unrelated parties would not have charged for such services.

11.3 USE OF TANGIBLE PROPERTY. – Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled entities is transferred by lease or other arrangement to another member of such group without charge or at a charge which is not equal to an arm's length rental charge, the Commissioner may make appropriate adjustments and allocations to properly reflect such arm's length charge. Where possession,

use, or occupancy of only a portion of such property is transferred, the determination of the arm's length charge and the adjustment and allocation shall be made with reference to the portion transferred.

An arm's length rental charge shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period of use and location of the used property, the owner's investment in the property, the type of property involved, its condition, and all other relevant facts.

11.4. SALE OF TANGIBLE PROPERTY. – Where one member of a group of controlled entities sells or otherwise disposes of tangible property to another member of such group at other than an arm's length price, or at a controlled sale, the Commissioner may make appropriate adjustments and allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition.

An arm's length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.

11.5. TRANSFER OR USE OF INTANGIBLE PROPERTY. – Where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities to another member of the group for other than an arm's length consideration, the Commissioner may make appropriate allocations to reflect an arm's length consideration for such property or its use.

11.5.1 The transfer of intangibles between related parties may be carried out as an outright sale or transfer for consideration, by way of gift or capital contribution, or in the form of lease or license where royalty is paid to the owner. Due to the nature of intangibles which are essentially unique assets, the following shall be considered:

11.5.1.1. Determination of whether the intangible actually exists. Marketing activities comprising of market research, product promotion, etc. need not necessarily result in the creation of a business asset; likewise not all research and development expenditures lead to the production of an

intangible (patent). The treatment of these activities will have a bearing on the functional analysis carried out to establish comparability.

11.5.1.2. Evaluation of the terms of agreement between the transferor and transferee taking into account the following:

- (i.) Whether the transfer is an outright sale or a licensing agreement for royalties to be paid;
- (ii.) If royalty is to be paid, the basis of payment;
- (iii.) Whether the price of product transferred included compensation for use of intangible property, and if so, whether other payments such as payment for provision of technology or rendition of services are also made in relation to the same product;

11.5.2 The arm's length principle, the concept of comparability and the basis of choosing the most appropriate method all apply to intangibles just as they do to tangible property. A comparability analysis shall take into account:

11.5.2.1. The expected benefits from the intangible property in both the controlled and uncontrolled transactions.

11.5.2.2. In the case of a patent, the nature and duration of the patent, the patent laws in the relevant countries, the value (of the final product) that is attributable to the patent;

11.5.2.3. In the case of marketing intangibles (trademarks and trade names), the value added by the trademark taking into account consumer acceptability, geographical significance, market share, sales volumes, etc.;

11.5.2.4. It is acknowledged that finding comparable uncontrolled transactions for intangibles will be a difficult task. For this reason, the residual profit split method is often the best method for

application. In determining comparability or relative value of contributions of each party, the amount, nature, and incidence of the costs incurred in developing or maintaining the intangible property shall be examined.

SECTION 12. Documentation – The main objective of preparing and maintaining documentation is to place the taxpayer in a position where it can readily demonstrate that it has exerted reasonable efforts to ensure that its transfer prices are consistent with the arm’s length principle. Therefore, adequate documentation will facilitate reviews by tax authorities on taxpayer’s transfer pricing analyses and hence assist in resolving any transfer pricing issues that may arise.

Adequate documentation is characterized by both the sufficiency of the details kept to demonstrate compliance with the arm’s length principle, as well as the timely manner in which the details are prepared.

Each taxpayer shall determine transfer pricing for tax purposes in accordance with the arm’s length principle, based upon information reasonably available at the time of the determination. Taxpayers should exert reasonable efforts to undertake a sound transfer pricing analysis to ascertain the arm’s length pricing as well as to demonstrate that such analysis has been performed. The keeping of records to demonstrate that such efforts have been undertaken to conform to the arm’s length principle is known as “documentation”.

The BIR shall make a determination of arm’s length transfer pricing even if the information available is incomplete. As a result, the taxpayers must consider that adequate records-keeping practices and the voluntary production of *bona fide* documents can improve the persuasiveness of their approach to transfer pricing.

This section describes the key principles and provides guidance on the types of documentation that taxpayers should keep to demonstrate that reasonable efforts have been taken to comply with the arm’s length principle.

BIR is conscious that keeping adequate documentation may result in compliance and administrative costs for taxpayers. Thus, BIR adopts the following principles with regard to documentation:

- (a) Taxpayers are only required to prepare or obtain documents necessary to allow a reasonable assessment of whether they have complied with the arm’s length principle.

Hence, on how extensive documentation should be, taxpayer's decision should be based on a balance between the need to show that the arm's length principle is complied with and the additional administrative costs. In this regard, taxpayers should evaluate the substantiality and complexity of the related party transactions as well as the costs of compliance arising from documentation.

Taxpayers are not expected to go to such lengths that the compliance costs arising from the preparation of documentation are disproportionate to the amount of tax revenue at risk, or to the complexity of the transactions. Conversely, scant documentation kept for complex and significant related party transactions may pose a risk of the transfer pricing being reviewed and challenged on whether it complies with the arm's length principle.

- (b) Existing tax laws on record-keeping requirement should be complied with by taxpayers.
- (c) There are good reasons for taxpayer to keep adequate documentation.

Firstly, it is a generally accepted international principle that by keeping adequate documentation, the taxpayer has further discharged its burden of proof to show that it has complied with the arm's length principle. This would put the taxpayer in a better stead to defend its transfer pricing analysis and prevent transfer pricing adjustments arising from tax examinations by tax authorities.

Secondly, in considering taxpayers' application for MAP, BIR would assess the quality of taxpayers' documentation. Taxpayers who have not prepared adequate documentation may find their application for MAP rejected or that the transfer pricing issue would be much more difficult to resolve.

- (d) BIR does not require documentation to be submitted when the tax returns are filed. The documentation should be kept by the taxpayers and submitted to BIR only when requested to do so.

For administrative ease, taxpayers may wish to consider aligning the retention period for documentation with the record keeping requirement specified in the Tax Code. However, it is prudent for a taxpayer to maintain the documentation for as long as there is a possibility of being subject to transfer pricing examinations or if the taxpayer is involved in a MAP.

The herein-below *“Guidance on Documentation Requirements”* lists the types of information (not exhaustive) that may be helpful in substantiating that the taxpayer’s transfer pricing analyses are in accordance with the arm’s length principle and that the taxpayer has made reasonable efforts to determine arm’s length transfer prices, margins or allocations.

However, the documentation required depends on the specific facts and circumstances of each case. It is not possible to specify a comprehensive list of documentation requirements that meet the needs of all taxpayers. Since taxpayers have the most intimate knowledge of their businesses and hence are in the best position to explain their approach to transfer pricing, taxpayers should include all other relevant information (even though not suggested in the *“Guidance on Documentation Requirements”*) in their documentation.

The details on what should be documented or the “Guidance on Documentation Requirements” includes the following:

(a) General Information on the Group –

- (i) Details on worldwide organizational structure, showing the location and ownership linkages amongst all related parties;
- (ii) Information on the group’s line of business, industry dynamics, market, regulatory and economic conditions in which the group operate;
- (iii) The group’s business models and strategies (past, present and future);
- (iv) Brief information on the principal business activities and functions of each party in the group;
- (v) Brief information on the business relationships (services provided, goods sold, intangible use, etc.) amongst all related parties; and
- (vi) Consolidated financial statements of the group for the last three (3) years, including the year when the controlled transactions occurred.

(b) Information on each Related Party in Philippines (“Philippine Entity”) –

- (i) General information such as company registration number, address, etc.;

(ii) Detailed information on the entity's line of business, industry dynamics, market, regulatory and economic conditions in which the entity operate;

(iii) Detailed information on the entity's business models and strategies (past, present and future);

(iv) Detailed information on the entity's functions, risks and assets employed; and

(v) Financial statements including detailed profit & loss statements for the last three (3) years, including the year when the controlled transactions occurred.

(c) Details on Transactions between Philippine Entity and all Related Parties

(i) Detailed information on all transactions with related parties;

(ii) Contracts or agreements (if any) to show the terms of the transactions; and

(iii) Segmented financial accounts with respect to the transactions, including explanations on the assumptions (if any) used to derive the segmented information for the last three (3) years, including the year when the controlled transactions occurred.

(d) Transfer Pricing Analysis –

(i) The choice of the tested party and reasons supporting the choice;

(ii) Details on comparables and the screening criteria for choosing the comparables;

(iii) Comparability analysis of the related party transactions and the comparables;

(iv) Details of (and reasons for) the adjustments deemed necessary to be made to achieve comparability;

(v) The transfer pricing method chosen and substantiate why the method is most appropriate;

(vi) The determination of the arm's length price/margin, showing the detailed computation and explanation of any assumption made; and

(vii) If an arm's length range is determined, furnish details/reasons to support the determination and use of the range.

(e) Other relevant information-

Other useful information, such as a list of any known comparable independent companies having transactions similar to the controlled transactions, etc.

12.1. Submission Period. – Documents required of the taxpayer by the Bureau of Internal Revenue, through its duly authorized officers or employees, must be provided within forty (45) days upon the request. However, the Commissioner of Internal Revenue or his duly authorized representative may, in his discretion, extend the period for producing the documents.

12.2. Retention Period. – In general, the documents required to be retained must be retained within the period specifically provided in the Tax Code as the retention period, unless a different period is otherwise legally provided.

SECTION 13. PENALTIES. – The provisions of the Tax Code and such other applicable laws regarding the imposition of penalties and other appropriate sanctions shall be applied to any person who fails to comply with or violates the provisions and requirements of these regulations .

SECTION 14. IMPLEMENTING DETAILS. – To further provide for the rules on transfer pricing arrangements under these Regulations, the Commissioner shall issue such issuances as may be necessary and relevant.

SECTION 15. TRANSITORY PROVISION- Transactions entered into prior to the effectivity of these Regulations shall be governed by the laws and other administrative issuances prevailing at the time the controlled transactions were entered into.

SECTION 16. SEPARABILITY CLAUSE. – If any part or provision of these Regulations shall be held to be unconstitutional or invalid, other provisions hereof which are not affected thereby shall continue to be in full force and effect.

SECTION 17. REPEALING CLAUSE. – All existing rules, regulations and other issuances or portions thereof inconsistent with the provisions of these regulations are hereby modified, repealed or revoked accordingly

SECTION 18. EFFECTIVITY. – These regulations shall take effect after fifteen (15) days following publication in the Official Gazette or a newspaper of general circulation, whichever comes first.

MARGARITO B. TEVES
Secretary of Finance

Recommending Approval:

JOSE MARIO C. BUÑAG
Commissioner of Internal Revenue