REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE

Quezon City

January 23, 2013

REVENUE REGULATIONS NO. 2-2013

SUBJECT : Transfer Pricing Guidelines

TO : All Internal Revenue Officers and Others Concerned

BACKGROUND. – The dramatic increase in globalization of trade has also led to harmful tax practices that have resulted in tremendous losses of tax revenues for governments. The most significant international tax issue emerging from globalization confronting tax administrations worldwide is transfer pricing.

Transfer pricing is generally defined as the pricing of cross-border, intra-firm transactions between related parties or associated enterprises.[1] Typically, a transfer price occurs between a taxpayer of a country with high income taxes and a related or associated enterprise of a country with low income taxes. In the Philippines, "intra-firm / inter-related" transactions account for a substantial portion of the transfer of goods and services, however, the revenue collection from related-party groups continue to go on a downtrend.

The revenues lost from intra-related transactions can be attributed to the fact that related companies are more interested in their net income as a whole (rather than as individual corporations), as such there is a desire to minimize tax payments by taking advantage of the loopholes in our tax system.

While transfer pricing issue typically occurs in cross-border transactions, it can also occur in domestic transactions. One context where transfer pricing issue occurs domestically is where one associated enterprise, entitled to income tax exemptions, is being used to allocate income away from a company subject to regular income taxes. In the Philippines, there

[1] UN Practical Manual on Transfer Pricing for Developing Countries

is a domestic transfer pricing issue when income are shifted in favor of a related company with special tax privileges such as Board of Investments (BOI) Incentives and Philippine Economic Zone Authority (PEZA) fiscal incentives or when expenses of a related company with special tax privileges are shifted to a related company subject to regular income taxes or in other circumstances, when income and/or expenses are shifted to a related party in order to minimize tax liabilities

SECTION 1. OBJECTIVE AND SCOPE. – Pursuant to the provision of Section 244 in relation to Section 50 of the National Internal Revenue Code of 1997, as amended ("Tax Code") these regulations are hereby promulgated to:

a. implement the authority of the Commissioner of Internal Revenue ("Commissioner") to review controlled transactions among associated enterprises and to allocate or distribute their income and deductions in order to determine the appropriate revenues and taxable income of the associated enterprises involved in controlled transactions;

b. prescribe guidelines in determining the appropriate revenues and taxable income of the parties in the controlled transaction by providing for the methods of establishing an arm's length price ; and

c. require the maintenance or safekeeping of the documents necessary for the taxpayer to prove that efforts were exerted to determine the arm's length price or standard in measuring transactions among associated enterprises.

These Regulations apply to:

(1) cross-border transactions between associated enterprises; and

(2) domestic transactions between associated enterprises.

SECTION 2. PURPOSE OF THE REGULATIONS. – These Regulations seek to provide guidelines in applying the arm's length principle for cross-border and domestic transactions between associated enterprises.

These guidelines are largely based on the arm's length methodologies as set out under the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines.

SECTION 3. AUTHORITY OF THE COMMISSIONER TO ALLOCATE INCOME AND DEDUCTIONS. – Pursuant to Section 50 of the Tax Code, the Commissioner is authorized to distribute, apportion or allocate gross income or deductions between or among 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, if he determines that such distribution, apportionment or allocation is necessary in order to clearly reflect the income of any such organization, trade or business.

Thus, the Commissioner is authorized to make transfer pricing adjustments, in line with the purpose of Section 50 to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions.

SECTION 4. DEFINITION OF TERMS. – As used in these Regulations, the following terms shall have the following meaning:

Comparable transaction. A transaction that is comparable to the controlled transaction under examination taking into consideration factors such as the nature of the property or services provided between the parties, functional analysis of the transactions and parties, contractual terms, and economic conditions.

Comparable uncontrolled transaction. A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transactions under examination. It can be either a comparable transaction between one party to the controlled transaction and an independent party ("internal comparable") or between two independent parties, neither of which is a party to the controlled transaction ("external comparable")

Associated enterprises. Two or more enterprises are associated if one 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 the enterprises. These are also referred to as related parties.

Control refers to any kind of control, direct or indirect, whether or not legally enforceable, and however exercisable or exercised. Moreover, control shall be deemed present if income or deductions have been arbitrarily shifted between two or more enterprises.

Controlled transaction means any transaction between two or more associated enterprises.

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

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 those transactions over a fixed period of time.

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 in Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

SECTION 5. ARM'S LENGTH PRINCIPLE.– The Bureau of Internal Revenue (the "Bureau") hereby adopts and the use of arm's length principle as the most appropriate standard to determine transfer prices of related parties.

a. Background and Concept:

The arm's length principle is the internationally recognized standard for transfer pricing between associated enterprises. Paragraph 1 of Article 9 of Philippine tax treaties is virtually identical to paragraph 1 of Article 9 of the OECD Model Tax Convention on Income and Capital, which is considered, in the international arena, as the authoritative statement of the arm's length principle.

Paragraph 2 of Article 7 (Business Profits) of the OECD Model Tax Convention on Income and on Capital specifies that, when attributing the profits to a permanent establishment, the permanent establishment should be considered as 'a distinct and separate enterprise engaged in the same or similar activities and under the same or similar conditions'. This corresponds with the application of the arm's length principle specified in paragraph 1 of Article 9 (Associated Enterprises) of the OECD Model Tax Convention on Income and on Capital.

The arm's length principle requires the transaction with a related party to be made under comparable conditions and circumstances as a transaction with an independent party. It is founded on the premise that

where market forces drive the terms and conditions agreed in an independent party transaction, the pricing of the transaction would reflect the true economic value of the contributions made by each entity in that transaction. Essentially, this means that if two associated enterprises derive profits at levels above or below the comparable market level solely by reason of the special relationship between them, the profits will be deemed as non-arm's length. In such a case, tax authorities that adopt the arm's length principle can make the necessary adjustments to the taxable profits of the related parties in their jurisdictions so as to reflect the true value that would otherwise be derived on an arm's length basis.

b. Guidance on the Application of the Arm's Length Principle:

The application of arm's length principle would, first and foremost, involve the identification of comparable situation(s) or transaction(s) undertaken by independent parties against which the associated enterprise transaction or margin is to be benchmarked. This step is commonly known as "comparability analysis". It entails an analysis of the similarities and differences in the conditions and characteristics that are found in the associated enterprise transaction with those in an independent party transaction. Once the impact of these similarities or differences have on the transfer price have been determined, the arm's length price/margin (or a range) can then be established using an appropriate transfer pricing method.

In the application of the arm's length principle the following 3-step approach, discussed in detail in Sections 6, 7, and 8 of these Regulations, may be observed.

Step 1: Conduct a comparability analysis.

Step 2: Identify the tested party and the appropriate transfer pricing method.

Step 3: Determine the arm's length results.

These steps should be applied in line with the key objective of transfer pricing analysis to present a logical and persuasive basis to demonstrate that transfer prices set between associated enterprises conform to the arm's length principle.

SECTION 6. COMPARABILITY ANALYSIS.

a. The Concept of Comparability

The arm's length principle is based on a comparison of the prices or margins adopted or obtained by related parties with those adopted or obtained by independent parties engaged in similar transactions. For such price or margin comparisons to be meaningful, all economically relevant characteristics of the situations being compared should be sufficiently similar so that:

(1) none of the differences (if any) between the situations being compared can materially affect the price or margin being compared, or

(2) reasonably accurate adjustments can be made to eliminate the effect of any such differences.

b. Factors Affecting Comparability

A comparability analysis should examine the comparability of the transactions in 3 aspects:

(1) Characteristics of Goods, Services or Intangible Properties

(i) The specific characteristics of goods, services or intangible properties play a significant part in determining their values in the open market. For instance, a product with better quality and more features would, ceteris paribus, fetch a higher selling price. Such product or service differentiation affects the price or value of the product or service. Hence, the nature and features of the goods, intangible properties or services transacted between related parties and those between independent parties must be examined carefully. The similarities and differences (which would influence the value of the goods, services or intangible properties) should be identified.

(ii) Characteristics to be examined include, but are not limited to, the following:

- in the case of transfer of goods: the physical features, the quality and reliability, and the availability and volume of supply of the goods;
- in the case of provision of services: the nature and extent of the services; and
- in the case of intangible property: the form of transaction, the type of intangible, the duration and degree of protection, and the anticipated benefits from the use of the property.

(iii) Similarities in the actual characteristics of the product, intangible or service, are most critical when one needs to compare prices of related party transactions against independent ones, such as when the Comparable Uncontrolled Pricing (CUP) method is adopted as the transfer pricing method. On the other hand, comparisons of profit margins (used in methods other than CUP) may be less sensitive to the features and characteristics of the product or service in question, as the margins generally correlate more significantly with the functions performed, risks borne and assets used by the entity.

(2) Analysis of Functions, Risks and Assets

(i) Economic theory purports that the level of return derived by an entity should be directly correlated to the functions performed, the assets used and risks assumed. For instance, an entity selling a product with warranty should earn a higher return compared to another entity selling the same product without the provision of warranty. The difference in margin is due to the additional function performed and risk borne by the first entity. Likewise, a product with a reputable branding is expected to fetch a higher return compared to that of a similar product without the branding, due to the additional asset (in this case, trademark) employed in enhancing the value of the product.

(ii) Hence, a crucial step in comparability analysis must entail a comparison of the economically significant functions performed, risks assumed and assets employed by the related party with those by the

independent party (which has been selected as the party against which the associated enterprise's margin or transactions are to be benchmarked). This is typically known as conducting a "functional analysis".

(iii) The functions that should be compared include (but are not limited to) design, research and development, manufacturing, distribution, sales, marketing, logistics, advertising, financing, etc.

(iv) It is also relevant and useful, when 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, valuable intangibles, etc. and the nature of the assets used (i.e., the age, market value, location, availability of intellectual property protections), etc.

(v) An appraisal of risks is also important in determining arm's length prices/margins. The possible risks assumed that should be considered in the functional analysis include market risks, risks of change in cost, price or stock, risks relating to the success or failure of R&D, financial risks such as changes in the foreign exchange and interest rates, credit risks, etc.

(vi) In practice, one cannot be expected to compare all functions, risks and assets employed. Hence, it must be emphasized that only functions, risk and assets that are economically significant in determining the value of transactions or margins of entities should be identified and compared.

(3) Commercial and Economic Circumstances

(i) Prices may vary across different markets even for transactions involving the same property or services. In order to make meaningful comparisons of prices or margins between entities/transactions, the markets and economic conditions in which the entities operate or where the transactions are undertaken should be comparable. the economic circumstances that may be relevant in determining market comparability include

the availability of substitute goods or services, geographic location, the market size, the extent of competition in the markets, consumer purchasing power, the level of the market at which the enterprises operate (i.e., wholesale or retail), etc.

(ii) Government policies and regulations (such as price controls, national insurance, etc.) may have an impact on prices and margins. Hence, the effects of these regulations should also be examined as part of the examination for comparability of the market and economic conditions.

(iii) Business strategies should 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 and other factors bearing upon the daily conduct of business.

(iv) An entity may embark on business strategies of temporarily charging a lower price for its product compared to similar products in the market or incurring higher expenses in the short run (hence resulting in lower profit levels). Such strategies are commonly used for market penetration and market share expansion or defense. The key issue with respect to business strategies that temporarily reduce profits in anticipation of higher long-term profit is whether the adoption and outcome of such strategies produce an arm's length result. Hence, a claim that such strategies have been adopted ought to be demonstrated with evidence that that an independent party would have been prepared to sacrifice profitability for a similar period under similar economic circumstances and competitive conditions, so that a higher long-term profit can be realized.

SECTION 7. IDENTIFICATION OF THE TESTED PARTY AND THE APPROPRIATE TRANSFER PRICING METHOD.

a. Determination of the Tested Party

The tested party is the entity to which a transfer pricing method can be most reliably applied to and from which the most reliable comparables can be found. For an entity to become a tested party, the Bureau requires sufficient and verifiable information on such entity.

b. Selection and application of Transfer Pricing Methodologies (TPM)

(1) The specific methods to be used in determining the arm's length price are discussed in Section 10 of these Regulations.

(2) The selection of a transfer pricing method is aimed at finding the most appropriate method for a particular case. Accordingly, the method that provides the most reliable measure of an arm's length result shall be used. For this purpose, the selection process should take into account the following:

(i) the respective strengths and weaknesses of each of the transfer pricing methods;

(ii) the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis;

(iii) the availability of reliable information (in particular on uncontrolled comparables) in order to apply the selected method and/or other methods; and

(iv) the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.

(3) The Bureau does not have a specific preference for any one method. Instead, the TPM that produce the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments, should be utilized.

(4) In exceptional circumstances where there may not be comparable transactions or sufficient data to apply the above-described methods the Bureau may use the following approaches to verify whether the controlled transactions comply with the arm's length principle:

(i) Extension of the transfer pricing methods. The comparable may be with enterprises in another industry segment or group of segments; and

(ii) Use of a combination or mixture of the transfer pricing methods or other methods or approaches.

(5) In all cases, taxpayers should be able to explain why a specific TPM is selected or used in recording controlled transactions through proper documentation.

c. Selection of Profit Level Indicator (PLI)

(1) In applying the TPM, due consideration must given to the choice of PLI which measures the relationship between profits and sales, costs incurred or assets employed. The use of an appropriate PLI ensures better accuracy in the determination of the arm's length price of a controlled transaction. PLI is presented in the form of a generally recognized or utilized financial ratio. The selection of an appropriate PLI depends on several factors, including:

(i) characterization of the business;

(ii) availability of comparable data; and

(iii) the extent to which the PLI is likely to produce a reliable measure of arm's length profit.

(2) Commonly used PLI include:

(i) Return on costs: cost plus margin and net cost plus margin.

(ii) Return on sales: gross margin and operating margin.

(iii) Return on capital employed: return on operating assets.

SECTION 8. DETERMINATION OF THE ARM'S LENGTH RESULTS. - Once the appropriate transfer pricing method has been identified, such is applied on the data of independent party transactions to arrive at the arm's length result.

In some cases, it will be possible to apply the arm's length principle to arrive at a single figure or specific ratio (e.g. price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. However, it is generally difficult to arrive at a specific ratio or range of deviation that may be considered as arm's length. More likely, the transfer pricing analysis would lead to a range of ratios. Hence, the use of ranges to determine an arm's length range shall be applied, provided that the comparables are reliable.

a. If the relevant condition of the controlled transaction (i.e. price or margin) is within the arm's length range, no adjustment should be made. If the relevant condition of the controlled transaction (e.g. price or margin) falls outside the arm's length range asserted by the Bureau, the taxpayer should present proof or substantiation that the conditions of the controlled transaction satisfy the arm's length principle, and that the result falls within the arm's length range (i.e. that the arm's length range is different from the one asserted by the tax administration). If the taxpayer is unable to establish this fact, the Bureau must determine the point within the arm's length range to which it will adjust the condition of the controlled transaction.

b. In determining this point, where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm's length principle. Where comparability defects remain, it may be appropriate to use measures of central tendency to determine this point (for instance the median, the mean or weighted averages, etc., depending on the specific characteristics of the data set), in order to minimise the risk of error due to unknown or unquantifiable remaining comparability defects.

SECTION 9. COMPARABILITY ADJUSTMENT. - Differences between the transaction of the comparables and that of the tested party must be identified and adjusted for, in order for the comparables to be useful as basis for determining the arm's length price. Comparability adjustments include accounting adjustments and function/risk adjustments.

a. Comparability adjustments are intended to eliminate the effects of differences that may exist between situations being compared and that which could materially affect the condition being examined in the methodology (e.g. price or margin). These should not be performed to correct differences that have no material effect on the comparison, as these adjustments are neither routine nor mandatory in a comparability analysis. When proposing a

comparability adjustment, a resultant improvement or increase in the accuracy in the comparability should be demonstrated.

b. The following adjustments should be avoided as they do not improve comparability:

(1) adjustments that are questionable when the basis for comparability criteria is only broadly satisfied;

(2) excessive adjustments or adjustments that too greatly affect the comparable as such indicates that the third party being adjusted is in actually not sufficiently comparable;

(3) adjustments on differences that do not materially affect the comparability;

(4) highly subjective adjustments, such as on the difference in product quality.

SECTION 10. ARM'S LENGTH PRICING METHODOLOGIES.[2] – In determining the arm's length result, the most appropriate of the following methods may be used.

a. 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. Any difference between the two prices may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.

The use of the CUP Method to determine transfer price entails identification of all the differences between the product or service of the associated enterprise 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:

[2] For further guidance and examples, please refer to the Organisation for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines.

(1) Product characteristics such as physical features and quality;

(2) If the product is in the form of services, the nature and extent of such services provided;

(3) Whether the goods sold are compared at the same points in the supply or production chain;

(4) Product differentiation in the form of patented features such as trademarks, design, etc.;

(5) Volume of sales if it has an effect on price;

(6) Timing of sale if it is affected by seasonal fluctuations or other changes in market conditions;

(7) Whether cost of transport, packaging, marketing, advertising, and warranty are included in the deal;

(8) Whether the products are sold in places where the economic conditions are the same; and

(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.

b. **Resale Price Method (RPM)** - RPM 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, RPM 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 RPM to arrive at the arm's length price.

The starting point in RPM 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.

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:

(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);

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

(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;

(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;

(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.;

(6) Whether the reseller is given exclusive rights to resell the products;

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

(9) Whether the products are sold in places where the economic conditions are the same; and

(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.

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, RPM 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 RPM will produce better results.

c. **Cost Plus Method (CPM)** - CPM 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. CPM is most useful where semi-finished goods are sold between associated enterprises or where the controlled transaction involves the provision of services.

CPM 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 CPM 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 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 CPM are the aggregation of direct and indirect costs of production.

Comparability, when applying CPM, 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 CPM shall take into account the following:

(1) Functions or level of activities performed by the seller and the risks undertaken;

(2) Whether similar assets are employed in the controlled and uncontrolled transactions;

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

(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;

(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;

(6) Whether cost of transport, packaging, marketing, advertising, and warranty are included in the deal;

(7) Whether the products are sold in places where the economic conditions are the same; and

(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 RPM, fewer adjustments may be necessary to account for product differences under CPM 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 associated enterprise 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 appropriate adjustments to eliminate the effects of these differences.

d. **Profit Split Method (PSM)**. PSM 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 (or losses) 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 situations involving a unique intangible. The method is based on the concept that profits earned in a controlled transaction should be equitably allocated among associated enterprises involved in the transaction(s) on an economically valid basis that approximates the allocation of profits that would have been anticipated and reflected in an agreement made at arm's length.

Generally, the profit to be split is the operating profit, but 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:

(1) **Residual Profit Split Approach. –**The combined profits from the controlled transactions under examination are split in two stages.

(i) 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.

(ii) 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 (i.e. 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.

(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.

e. **Transactional Net Margin Method (TNMM)** – 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.

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.

In short, TNMM evaluates whether the amount charged in a controlled transaction is arm's length by reference to the operating profit earned in comparable uncontrolled transactions.

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 TNMM and RPM or CPM is that the former focuses on the net margin instead of the gross margin of a transaction. However, 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, TNMM may not produce reliable measures of the arm's length net margins.

TNMM is usually appropriate to use when the gross profit of the business is not easy to determine such that either CPM, in case of a manufacturer/service-provider, or RPM, in case of a distributor, cannot be used. Since the net margin figure is always available, TNMM may be used instead, applying the same formula as those for CPM (for manufacturer/service provider) or RPM (for distributor) but rather using net margin in lieu of the gross margin/profit.

SECTION 11. ADVANCE PRICING ARRANGEMENTS and MUTUAL AGREEMENT PROCEDURE. – An Advance Pricing Arrangement (APA) is a facility available to taxpayers who are engaged in cross-border transactions. It is an agreement entered into between the taxpayer and the Bureau to determine in advance an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto) to ascertain the transfer prices of controlled transactions over a fixed period of time. The purpose of an APA is to reduce the risk of transfer pricing examination and double taxation.

There are two kinds of APA: (i) Unilateral APA; and (ii) Bilateral or Multilateral APA. A unilateral APA is an agreement involving only the taxpayer and BIR, while a bilateral/multilateral APA is an agreement involving Philippines and one or more of its treaty partners. A Bilateral or Multilateral APA is authorized under the Mutual Agreement Procedure (MAP) Article of the 37 Philippine tax treaties.

It is not a mandatory requirement for taxpayers to avail of an APA for their controlled transactions. If a taxpayer avails of an APA, it may choose freely between a unilateral and bilateral/multilateral APA. If a taxpayer does not choose to enter into an APA and its transactions are subject later on to transfer pricing adjustments, it may still invoke the MAP Article to resolve double taxation issues.

The Philippine tax treaties' article on MAP provides a mechanism for the Philippine competent authority to mutually arrive at satisfactory solution with the competent authority of the treaty partner to eliminate double taxation issues arising from transfer pricing adjustments.

The Bureau shall issue separate guidelines on the application of APA and MAP processes.

SECTION 12. DOCUMENTATION.– Taxpayers must demonstrate that their transfer prices are consistent with the arm's length principle. The main purpose of keeping adequate documentation is for taxpayers to be able to (i) defend their transfer pricing analysis, (ii) prevent transfer pricing adjustments arising from tax examinations, and (iii) support their applications for MAP. 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.

a. **Retention Requirement** - The BIR does not require transfer pricing documents to be submitted when the tax returns are filed. However,

such documents should be retained by the taxpayers and submitted to BIR when required or requested to do so.

b. **Retention Period** - In general, transfer pricing documents must be retained preserved within the period specifically provided in the Tax Code as the retention period, unless a different period is otherwise legally provided. However, it is to the best interest of the taxpayer to maintain documentation for purposes of MAP and possible transfer pricing examination.

c. **Contemporaneousness** - The transfer pricing documents must be contemporaneous. It is contemporaneous if it exists or is brought into existence at the time the associated enterprises develop or implement any arrangement that might raise transfer pricing issues or review these arrangements when preparing tax returns.

d. ***Documentation Details*** – the details of transfer pricing documents include, but are not limited to, the following:

(1) Organizational structure

(2) Nature of the business/industry and market conditions

(3) Controlled transactions

(4) Assumptions, strategies, policies

(5) Cost contribution arrangements (CCA)

(6) Comparability, functional and risk analysis

(7) Selection of the transfer pricing method

(8) Application of the transfer pricing method

(9) Background documents

(10) Index to documents

SECTION 13. PENALTIES.– The provisions of the Tax Code and 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. 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 15. 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 16. 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 17. EFFECTIVITY.– This Regulations shall take effect after fifteen (15) days following publication in a newspaper of general circulation.

(Original Signed)
CESAR V. PURISIMA
Secretary of Finance

Recommending Approval:

(Original Signed)
KIM S. JACINTO-HENARES
Commissioner of Internal Revenue