REVENUE REGULATIONS NO. 2-2013 issued on January 23, 2013 prescribes the transfer pricing guidelines, particularly the guidelines in applying the arm’s length principle for cross-border and domestic transactions between associated enterprises, which are largely based on the arm’s length methodologies set out under the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines.

In the Philippines, there 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 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.

Per Section 50 of the Tax Code, the Commissioner of Internal Revenue 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.

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.

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 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 (TPM).

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.

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: a) none of the differences (if any) between the situations being compared can materially affect the price or margin being compared, or b) reasonably accurate adjustments can be made to eliminate the effect of any such differences.

A comparability analysis should examine the comparability of the transactions in three (3) aspects, namely: a) characteristics of goods, services or intangible properties; b) analysis of functions, risks and assets; and c) commercial and economic circumstances.

The tested party is the entity to which a TPM 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 BIR requires sufficient and verifiable information on such entity.

The selection of a TPM 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:

a. the respective strengths and weaknesses of each of the transfer pricing methods;
b. the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis;
c. the availability of reliable information (in particular on uncontrolled comparables) in order to apply the selected method and/or other methods; and

d. 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.

The BIR 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. In exceptional circumstances where there may not be comparable transactions or sufficient data to apply the above-described methods, the BIR may use the following approaches to verify whether the controlled transactions comply with the arm’s length principle:

a. Extension of the TPM. The comparable may be with enterprises in another industry segment or group of segments; and

b. Use of a combination or mixture of the transfer pricing methods or other methods or approaches.

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

In applying the TPM, due consideration must be given to the choice of Profit Level Indicator (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: a) characterization of the business; b) availability of comparable data; and c) the extent to which the PLI is likely to produce a reliable measure of arm’s length profit.

Once the appropriate TPM 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.
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 BIR, 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 BIR must determine the point within the arm’s length range to which it will adjust the condition of the controlled transaction.

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. When proposing a comparability adjustment, a resultant improvement or increase in the accuracy in the comparability should be demonstrated. The following adjustments should be avoided as they do not improve comparability:

a. adjustments that are questionable when the basis for comparability criteria is only broadly satisfied;
b. excessive adjustments or adjustments that too greatly affect the comparable as such indicates that the third party being adjusted is actually not sufficiently comparable;
c. adjustments on differences that do not materially affect the comparability;
d. highly subjective adjustments, such as on the difference in product quality.

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.

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.

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.

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.

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 evaluates whether the amount charged in a controlled transaction is arm’s length by reference to the operating profit earned in comparable uncontrolled transactions.

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

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.

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. 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.

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. The details of transfer pricing documents include, but are not limited to, the following:

a. Organizational structure
b. Nature of the business/industry and market conditions
c. Controlled transactions
d. Assumptions, strategies, policies
e. Cost contribution arrangements
f. Comparability, functional and risk analysis
g. Selection of the transfer pricing method
h. Application of the transfer pricing method
i. Background documents
j. Index to documents