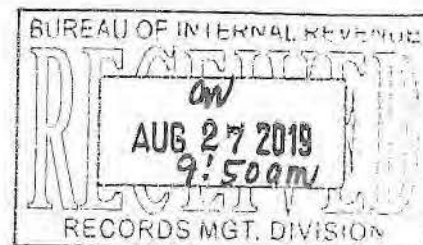




REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE



August 20, 2019

REVENUE AUDIT MEMORANDUM ORDER NO. 1-2019

SUBJECT : *Transfer Pricing Audit Guidelines*
TO : *All Internal Revenue Officers and Others Concerned*

I. OBJECTIVE

The Transfer Pricing Audit Guidelines is intended to supplement Revenue Audit Memorandum Order (RAMO) No. 1-2000 (Updated Handbook on Audit Procedures and Techniques Volume 1) and RAMO No. 1-2008 (Computer Assisted Audit Tools and Techniques), and to provide standardized audit procedures and techniques in the conduct of audit of taxpayers with related party and/or intra-firm transactions in order to ensure quality audit.

II. PURPOSE

The Transfer Pricing Audit Guidelines provides a framework and guide for transfer pricing examinations. Every transfer pricing issue is unique, and teams should exercise their judgement on how to best apply this guide.

III. SCOPE

1. The Guidelines are applicable on controlled transactions including sale, purchase, transfer and utilization of tangible and intangible assets, provision of intra-group services, interest payments and capitalization among others, between related/associated parties, where at least one party is assessable or chargeable to tax in the Philippines.
2. The Guidelines are also applicable by analogy, in relation to transactions between permanent establishment (PE) and its head office or other related branches. For the purpose of the Guidelines, the PE will be treated as a separate and distinct enterprise from its head office or other related branches/subsidiaries for tax purposes.

IV. REPORTING REQUIREMENTS


Revenue Officers are required to make a report after the audit has been conducted.

IV. REPEALING CLAUSE

This order supersedes all revenue issuances or portions thereof inconsistent herewith.

V. EFFECTIVITY

All revenue officers and other employees concerned are hereby directed to use the aforesaid Manual in the audit/investigation of tax returns immediately after the approval of this Order.


CAESAR R. DULAY

Commissioner of Internal Revenue

028132

TRANSFER PRICING AUDIT GUIDELINES

This Audit Manual was completed under the administration of Commissioner of Internal Revenue CAESAR R. DULAY.

Acknowledgement is given to Deputy Commissioner, ARNEL SD. GUBALLA and OIC-Assistant Commissioner TERESITA M. DIZON of the Large Taxpayers Service for spearheading the project and for their invaluable contribution. Acknowledgement is also extended to Ms. LISA A. CEA for her technical advice.

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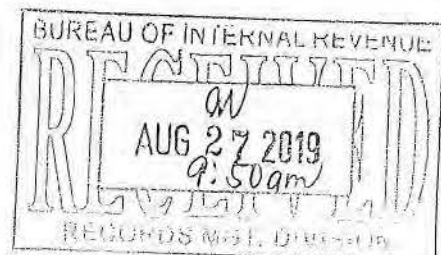
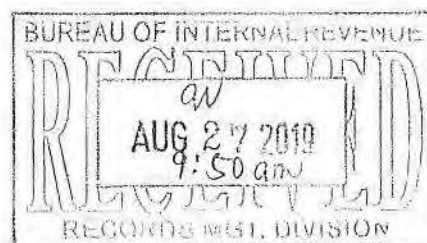


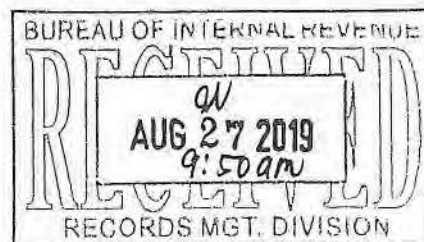
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CHAPTER I

Introduction



Globalization spurs up multinational corporations in expanding out their business activities globally. The fast pacing progress in technology, communication and transportation make it accessible for them to determine their business options through investment and sale/purchase transactions between countries. High production costs and saturation of domestic markets lead them to look into other countries where they could have advantages in production costs (location saving) and in market share (market premium).

The rapid growth of multinational corporation entails an increase of related transactions globally. This special relation may evoke the possibility that income or profit may be reported smaller than the actual one or costs/expenses may be claimed excessively. These related transactions include sale, purchase, transfer and utilization of tangible and intangible assets, provision of intra-group services, interest payments and capitalization among others. Some of the reasons that drive the group of companies in setting up the transfer prices for related party transactions include minimizing tax, repatriation of capital, exchange rate difference risk, and window dressing of the parent company's financial statements.

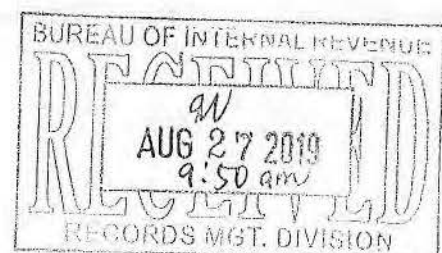
The transfer price in a related party transaction must conform with the arm's length principle (ALP) as mandated in Section 5 of Revenue Regulations (RR) No. 2-2013 (Transfer Pricing Guidelines). This principle stipulates that if the conditions in the transaction between related parties are the same as or similar to the conditions in transaction between the independent parties that are used as comparable, the price or profit in the related transactions must be the same as or similar to the range of prices or profit in the transactions between the comparable independent parties.

The Commissioner of Internal Revenue (CIR), as stipulated in Section 50 of the National Internal Revenue Code and as implemented under RR No. 2-2013 has the authority to review, allocate and distribute the income and deductions of the related party transaction (cross-border and domestic) including intra-firm transactions¹ between related parties to determine the appropriate revenue and taxable income by using the Comparable Uncontrolled Price Method (CUP), the Resale Price Method (RPM), the Cost Plus Method (CPM), the Profit Split Method (PSM), the Transactional Net Margin Method (TNMM) or other method.

Audit on transfer pricing on related transactions is a test of application of ALP to the related transactions, hence, these audit guidelines.

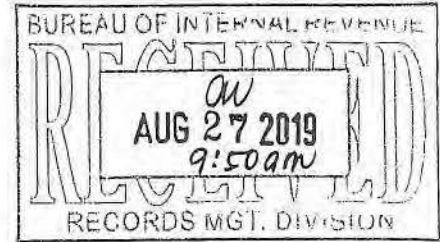
¹ Intra-firm transactions or misallocation of profits and costs occurs when a firm with activities in different tax regimes (i.e., income tax holiday, 5% gross income earned tax and regular corporate tax) manipulates revenues and costs to minimize tax liabilities.

- Annex 5 : Supply Chain Management Analysis
- Annex 6 : Function, Assets and Risks Analysis (FAR Analysis)
- Annex 7 : Characteristics of Business
- Annex 8 : Comparability Analysis
- Annex 9 : Supplemental Letter Request for Information on Affiliated Transactions
- Annex 10 : Minutes of Provision of Information on Taxpayer in Respect of
Affiliated Transactions



CHAPTER II

Audit Procedure on Transfer Pricing



Audit is a series of activities of collecting and processing data, information, and or proofs objectively and professionally based on an audit standard to test compliance in fulfillment of tax obligations and/or for other purposes in the context of implementing the provisions of the existing tax laws and regulations.

A transfer pricing audit is conducted to test the compliance in fulfillment of tax obligations of a taxpayer with related party transactions. Audit procedure on transfer pricing consists of Preparation, Implementation and Reporting.

In the preparation of audit, Revenue Officer should collect and learn taxpayer's data in respect of special relations with their related/associated parties.

Implementation of audit on transfer pricing comprises of the following: (1) Determination of the characteristics of the taxpayer's business; (2) Selection of the transfer pricing method; and (3) Application of the ALP.

Lastly, Reporting of Audit on transfer pricing is carried out in accordance with the audit procedure.

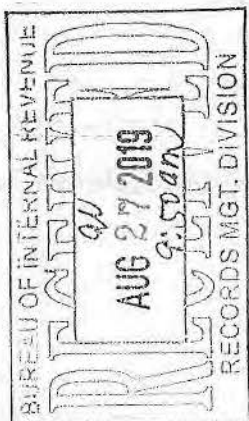
A. PREPARATION FOR TRANSFER PRICING AUDIT

This phase of the examination process determines the scope of the audit. Proper selection of issues and application of a transfer pricing method for transfer pricing examinations should have the broadest impact on achieving compliance regardless of the size or type of entity. The audit plan will be issue-focused and contain the following: issues identified, audit steps, timeline(s), and communication agreements. The Revenue Officer should coordinate with the taxpayer to establish a plan to complete the transfer pricing audit in a timely manner. The audit can be productive if the Revenue Officer and the taxpayer work together in a spirit of cooperation, responsiveness, and transparency. The audit plan may be adjusted throughout the process.

The steps in the audit preparation include the following:

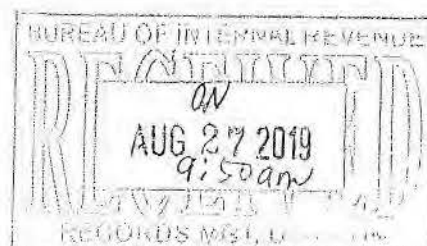
1. Review the available information relating to the taxpayer's related party transactions and its related parties such as Annual Income Tax Return and its attachments (Audited Financial Statements), Tax Treaty Relief Applications/Rulings and prior years audit reports, if any. Further research may be done about the taxpayer's background, history and core business operations through websites, commercial databases, or other sources of data to confirm the existence of a special relationship with the transaction counterparty.

2. Set a schedule for initial meeting with the taxpayer covering the general background of the taxpayer's business operations, key functions, product/service flow, worldwide structure, transfer pricing policy, transfer pricing (TP) documentation and other relevant information. The Revenue Officers may request for information/evidence of related party transactions together with other attachments. (Please see templates in Annexes 1-8.)
3. Evaluate the information and documents submitted.
4. Set for a transfer pricing orientation meeting with the taxpayer to discuss the initial findings including but not limited to:
 - a. Taxpayer's background and history of intercompany transactions
 - b. Discuss all intercompany transactions in the year(s) under examination.
 - Gain understanding of the taxpayer's rationale for entering into the transactions.
 - Gain understanding of the taxpayer's value chain(s) associated with the intangible, services, and/or tangible goods.
 - Gain understanding whether the intercompany transaction is associated with the transfer of an income stream, or contribution to the value, of any intangible.
 - c. Discuss the functions performed, assets employed, and risks assumed by each controlled party of the respective intercompany transaction.
 - d. Understand how the preparer of the transfer pricing study gained knowledge of each controlled party's functions performed, assets employed and risks assumed and request supporting documents (interview notes, minutes).
 - e. Discuss whether to request background documentation.
 - f. Identify persons responsible for structuring the transaction from the tax planning perspective.
 - g. Discuss the need to request additional documentation including contracts and agreements not previously requested.
 - h. Gain an understanding of the transfer pricing methods selected by the taxpayer for significant transactions.
 - i. Discuss the process for requesting follow-up meetings and clarifications.



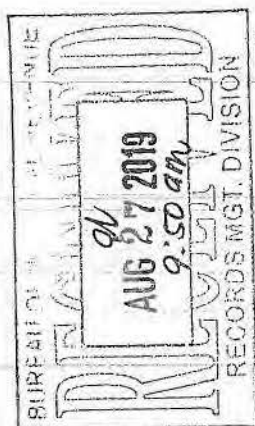
5. If needed, require the taxpayer's explanation through a Supplemental Letter Request for Information on Related Party Transactions (Annex 9) for clarification purposes.
6. The Revenue Officers shall analyze the risk of arm's length price in the related party transactions based on the results of the prior meetings and as set forth in the Annexes. Factors that need to be examined include the following:
 - a. Worldwide effective tax rate and whether the taxpayer's overall tax position is such that income shifting would be beneficial from a financial accounting/cash flow standpoint;
 - b. Potential applicability of a tax treaty;
 - c. Source of income and tax credit availability;
 - d. Materiality of related party transactions, which may be measured from their proportion to sales or to net operating profit;
 - e. Taxpayer's transactions with related parties domiciled/located in countries or economic zones with low or zero tax rates;
 - f. Related party transactions of a special nature, such as transfer of intangible assets (license), royalty payment, intra-group services, and interest expense;
 - g. Performance of the taxpayer's net operating profit is lower than that of other companies in the same industry;
 - h. Significance of related party transactions not included in the components of the taxpayer's net operating profit such as interest expense, gain/loss on sale of assets, and exchange rate gain/loss;
 - i. Non-routine types of related party transactions, such as business restructuring that involves or does not involve intangible assets and sales of intangible property; and
 - j. The taxpayer suffered losses over several years.

When the risks of related party transaction are present, the Revenue Officers shall include in the audit plan the appropriate method in determining arm's length price. If none, the Revenue Officers shall perform the testing in the implementation of the audit. Upon discovery of the risks, the audit plan shall be revised accordingly.



7. Set a schedule for re-assessment meeting with the taxpayer based on the following:

- a. Determine which transaction(s) need(s) further development, which transactions may be closed or which transaction(s) need(s) to be eliminated from further analysis;
- b. Determine the level and scope of TP involvement going forward;
- c. Discuss any new information and reassess/adjust working hypothesis(es);
- d. Assess level and scope of counsel involvement and begin to consider any discrete legal issues;
- e. Continue to document, organize and outline transactions determined to warrant further development and analysis based on information gathered to date; and
- f. Begin to formulate the best method analysis to include assessment of the taxpayer's selected method.
 - If there is doubt as to whether the taxpayer's selected method is the best method, assess the reliability and comparability of the taxpayer's assumptions and data.
 - Determine additional accounting data and records needed for this assessment for application of any methods being considered as a best method.



B. IMPLEMENTATION OF THE TRANSFER PRICING AUDIT

The implementation of the transfer pricing audit involves stages of issue development by determining the facts, applying the law to those facts, and understanding the various tax implications of the issue. The Revenue Officer and the taxpayer shall conduct interactive discussions and every effort should be made to resolve any factual differences. Communication and continuous reassessment should remain throughout the implementation process.

Implementation of audit on transfer pricing consist of the following steps:

1) Determination of the Characteristics of the Taxpayer's Business.

Every taxpayer has different characteristics; even within the same industry, each company has different strategy, organizational structure, and objectives. This stage is needed to understand the reality of the taxpayer's business. The Revenue Officers may gain an overview of the industry in which the taxpayer

operates, the business of the group of companies, and the main functions of each member of the company group based on the taxpayer's internal and external sources of information.

By determining the characteristics of the taxpayer's business and understanding the functions of its related parties, the Revenue Officers will gain an impression of the return expected by each of the parties in the transaction, as well as the risk/s of tax avoidance using transfer pricing transactions.

The accurate determination of the characteristics of the related transactions and the taxpayer's business will ease the selection of reliable comparable.

Measures in the determination of the characteristics of the taxpayer's business, among other things, are (a) identifying the characteristics of the related transactions of the taxpayer and by (b) conducting functional analysis.

a). Identify the Characteristics of the Related Transactions of the Taxpayer.

The Revenue Officers shall do an industry analysis by using external sources of information, including industry research reports, publicly available annual financial statements of the main players in the taxpayer's industry, data from the Securities and Exchange Commission (SEC), Transfer Pricing Documentation, and other information media available through the internet or in databases in order to gain a general understanding of the conditions of the taxpayer's industry. Analysis of the taxpayer's industry shall be done with consideration to several factors, including main characteristics of taxpayer's business and performance of the industry.

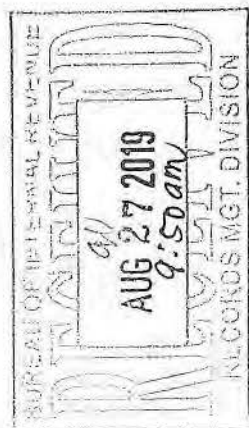
Understand the condition of the related transactions for comparability analysis. For purposes of identifying the related transactions, the following factors shall be considered:

a.1) Conditions that influence industry

- a.1.1) industry and market segment where the taxpayer carries on business, i.e. growth of industry, technology, size and growth of market;
- a.1.2) competitive condition of the taxpayer and its competitors; and
- a.1.3) economic factors and existing regulations that influence the taxpayer's business.

a.2) Conditions of the related transactions

- a.2.1) type and value of related transactions;



- a.2.2) the period and frequency/rate of the related transactions;
- a.2.3) terms of the agreement, including the set-off arrangement between the related parties;
- a.2.4) terms of contract, including term of delivery, discount;
- a.2.5) parties involved in the related transactions, as well as the relation between the parties, for example: parent-subsidiary relationship, joint venture, franchise, cost contribution arrangement; and
- a.2.6) chain of transaction in which the taxpayer's affiliated transactions become part of.

a.3) Functional role of the taxpayer in the Group

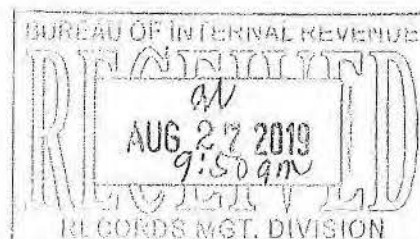
- a.3.1) structure of the taxpayer's organization in its group including the decision-making process;
- a.3.2) shareholding structure of the taxpayer in the group;
- a.3.3) strategies, policies, as well as targets of the taxpayer;
- a.3.4) function performed by each member of the group (supply chain management); and
- a.3.5) restructuring of taxpayer's business.

a.4) Financial ratio

In audit on transfer pricing, it is important to do early examination on financial performance of the taxpayer to identify the risk for tax avoidance by reason of the special relation. Prior examination can be done by getting the average ratio of the taxpayer's industry.

In applying the ALP, financial ratio (degree of gross/net profits) of the taxpayer will be compared to that of the financial ratio (degree of gross/net profits) of comparable companies to determine the ALP of the taxpayer's business.

The following are the financial ratios that can be used as basis/indicator for comparable:



a.4.1) Gross Margin to Sale Ratio

$$= \frac{\text{Gross profit}}{\text{Sale}}$$

a.4.2) Gross Profit to Basic Sale Price Ratio

$$(\text{Gross Mark-up}) = \frac{\text{Gross profit}}{\text{Basic Sale Price}}$$

a.4.3) Rate of Return of Sale Ratio

$$= \frac{\text{Net Operating Income}}{\text{Sale}}$$

a.4.4) Rate of Return of Total Costs Ratio

$$= \frac{\text{Net Operating Income}}{\text{HPP}^2 + \text{Total Operating Costs}}$$

a.4.5) Rate of Return of Assets (ROA) Ratio

$$= \frac{\text{Net Operating Income}}{\text{Total Operating Assets}^3}$$

a.4.6) Rate of Outcome of Capital Employed (ROCE) Ratio

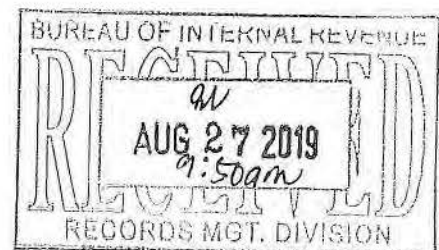
$$= \frac{\text{Net Operating Income}}{\text{Current Assets-Liabilities}}$$

a.4.7) Berry Ratio

$$= \frac{\text{Gross profit}}{\text{Operating Costs}}$$

a.4.8) Debts to Capital Ratio

$$= \frac{\text{Debts}}{\text{Capital}}$$



² High Price Points(HPP) are prices at which demand for a given product is supposed to stay relatively high.

³ Total Operating Assets are those assets acquired for use in the conduct of the ongoing operations of a business; this means assets are needed to generate revenue. Examples of operating assets are cash, prepaid expenses, accounts receivable and fixed assets.

a.4.9) Research and Development (R&D) Costs to Sale Ratio

$$= \frac{\text{R\&D Costs}}{\text{Sale}}$$

a.4.10) Marketing Costs to Sale Ratio

$$= \frac{\text{Marketing Costs}}{\text{Sale}}$$

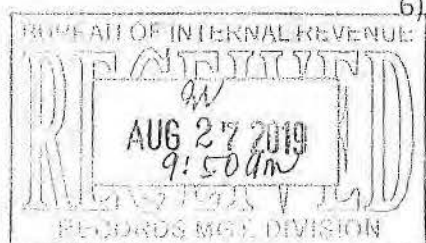
b) Make Functional Analysis.

Functional analysis is performed to obtain accurate identification on the characteristics of the taxpayer's business as well of their counterparts. By knowing them, the level of the risks borne and remuneration (profit) which are proportional with the risks borne by any of the parties can be predicted. For example, the characteristics of business of the parties who perform manufacturing function among others, are fully fledged manufacturing, contract manufacturing, and toll manufacturing. On the other hand, characteristics of the parties who perform distributor function, among other things, are fully fledged distributor, limited risk distributor, commissionaire, and commission agent.

FAR analysis is a mapping of the economically relevant facts and characteristics of related party transactions with attention to the Functions, Assets, and Risks (FAR) and the allocation of the functions, assets, and risks between the parties involved in the affiliated transactions to accurately know the characteristics of each party.

The Revenue Officers need to study several sources of information, including:

- 1) Organizational chart of the taxpayer under audit and structural chart of the group;
- 2) List of all employees, job descriptions, and the authorities of the employees involved in the economically relevant functions;
- 3) Audited financial statements;
- 4) Segmented financial statements (segmented both by function and by independence of transactions);
- 5) Global pricing policy document;
- 6) Licensing contracts for intangible assets to recognize the parties that own intangible assets and identify payments/ receipt of

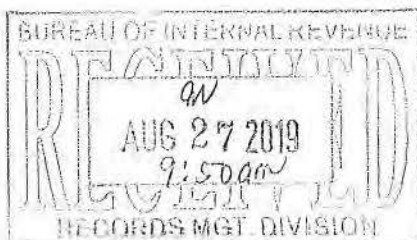


royalty to/from related parties; and

7) Transfer Pricing Documentation.

The Revenue Officers should focus on the following activities in performing FAR analysis:

- 1) Identify the significant/material economically relevant functions performed by the taxpayer, including design, processing, assembly, research and development, sale and distribution, purchase, provision of services, marketing, promotion, transportation, financing, and management and other related activities.
- 2) Identify the significant functions performed based on the following:
 - Transfer Pricing Documentation and/or FAR analysis form;
 - Taxpayer's financial statements; and
 - Organizational Chart.
- 3) Prepare questionnaire needed for interviews with key personnel that are involved in significant functions.
- 4) Conduct a review and analysis of accounting data, interviews, plant tours and site visitations.
 - Work with the taxpayer to identify key personnel for interviews /site tours.
 - Work with taxpayer to identify plan and site for tour(s).
 - Work with core members to prepare for interviews and tours.
 - Consider and evaluate for foreign travel.
- 5) The Revenue Officers need to prepare Minutes of Provision of Information in connection with information relevant to the FAR analysis (Annex 10).
- 6) During the interview, confirm the functions / contributions / participations performed by related parties regarding the related transactions, including:
 - a) Transactions with related parties that function as intermediaries in product sale/purchase transactions, the



Revenue Officers need to do research on the organizational chart, number and qualifications of personnel, and financial statements of the related parties, in order to confirm that these related parties have functions in the taxpayer's related party transactions.

- b) Transactions of transfer of intangible assets, the Revenue Officers need to confirm the qualifications (economic/legal ownership) of the party that receives the transfer of the intangible assets, i.e. considering the ability of the transferee in developing, protecting, or maintaining the intangible assets. This can be done by studying the organizational chart, number and qualifications of personnel, and financial statements of the related parties.
 - c) Transactions of provision of intra-group services, the Revenue Officers need to confirm the qualifications (beneficial) of the party that delivers the intra-group services. This can be done by studying the organizational chart and the number and qualifications of the personnel who provide the services.
- 7) Identify and/or confirm the types of assets used by the taxpayer, including land, buildings and machinery, use of valuable intangible assets, financial assets; and the nature of the assets that are used, including useful life, market value, location, and legal protection available for the intangible assets.

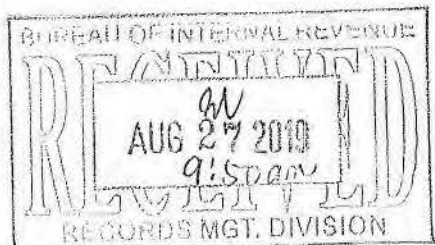
The following should be considered in identifying the use or existence of intangible assets:

- a) The company obtains a higher profitability level than the average for similar industries;
- b) The existence of the intangible assets is not determined by whether or not the intangible assets are recorded in the balance sheet;

Example 1:

Costs in connection with research, development and marketing of a product are often not capitalized but instead charged as expense at the time they occur. These costs may not be reflected in the balance sheet as assets.

- c) The existence of intangible assets is not determined by whether or not they have legal protection.



Example 2:

Intangible assets relating to the production process in the form of patents are commonly registered, while those in the form of know-how are commonly not registered, because the company owning the know-how takes the view that this information should be kept confidential.

Below are the types of intangible assets and the steps to identify their existence.

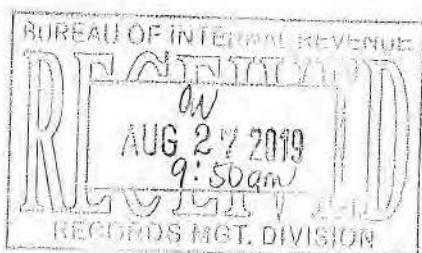
a) Manufacturing intangibles

Manufacturing intangibles are generally created through research and development activities, which are risky and entail expenses, so that the developer seeks to obtain compensation for the expenditure in connection with these activities and to seek profit through the sale of goods, license agreements, or service contracts. The developer of the intangible assets may engage in the research and development activities by itself, or in the name of one or more members of the company group, in these ways:

- (1) based on a service contract, in its own name or that of one or more members of the company group; and
- (2) based on an agreement whereby the members involved in the joint activity will be the economic owners of the manufacturing intangibles.

The Revenue Officers need to take the following steps to identify the existence of manufacturing intangibles:

- (1) Perform research on contracts, such as licensing contracts or sale contracts for the intangible assets.
- (2) Review the FAR analysis table relating to manufacturing functions and intangible assets used that has been filled in by the taxpayer (Annex 6).
- (3) Check the taxpayer's organizational chart regarding manufacturing functions, key personnel, and job descriptions of the key personnel.
- (4) Conduct site visits and interviews with factory managers and manufacturing engineers to confirm whether or not there is know-how or patents used in the factory, as well as its economic benefit.



- (5) Identify existence of unique production equipment or modifications made to the production equipment that boosts quality or reduces production costs.
- (6) Identify any changes in factory design that reduce production costs or increase in output.
- (7) Obtain a list of patents and conduct interviews with research and development personnel (or key persons related to patents) to determine whether the patents are used or not, and also to determine the value of the patents if any. The Revenue Officers may request the opinions of expert regarding the value of the patents for the taxpayer.
- (8) Conduct interviews with research and development personnel to determine the company's level of success in the market (market power) produced by each such patent.

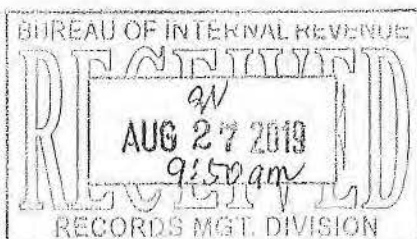
b) Marketing intangibles

Marketing intangibles include but are not limited to trademarks or trade names that help increase the marketing of goods and services, customers list, distribution channels, a unique name, symbol or picture that has important promotional value for the products.

The value of marketing intangibles depends on several factors, including the reputation and credibility of the brand or trade name, level of quality control and continuing research, distribution and availability of the goods and services that are marketed, success of promotion costs, and so on.

The Revenue Officers should do the following steps to identify the existence of marketing intangibles:

- (1) Conduct research on contracts relating to licenses (substance over form).
- (2) Review the FAR analysis table regarding marketing functions and intangible assets used that has been filled in by the taxpayer (Annex 6).
- (3) Check the taxpayer's organizational chart with regard to marketing function, key personnel and their job descriptions.



- (4) Conduct interviews with marketing/sales personnel to identify reasons for the products' success in the market.
- (5) Identify the existence of a series of activities that add value to the transaction.

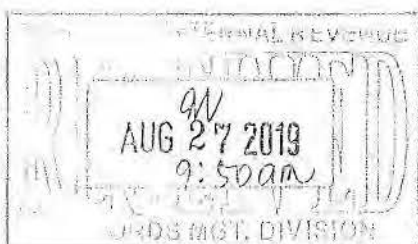
Example 3:

Strategic planning activities in the field of marketing, advertising activities that have a long-term impact on a product, and so on.

- (6) Identify the existence of successful distribution channels that make it easy for consumers to purchase the products and/or services. If necessary, the Revenue Officers may request the opinions of experts regarding the reasons for the success of the taxpayer's product in the market.
7. Map and/or confirm the risks borne by the taxpayer in connection with the affiliated transactions. This can be done by, for example, studying sale/purchase contracts, identifying write-off transactions, including those for uncollectible receivables, operating expenses in the form of loss from exchange rate differences, warranty expense, and inventory obsolescence. The Revenue Officers need to observe consistency between the party that bears the risk as stated in the contract and the facts and conditions in the field.

In performing FAR analysis, the Revenue Officers need to identify the taxpayer's contribution to the creation, development, protection and/or maintenance of the intangible assets. Factors that need to be considered in identifying the taxpayer's contribution include the following:

- a) Existence of research and development costs or marketing costs;
- b) Existence of a function relating to research and development performed by the taxpayer;
- c) Existence of a function of marketing performed by the taxpayer;
- d) Existence of risks of research and development and/or marketing risks that are borne by the taxpayer;
- e) Existence of personnel with special qualifications who are employed in the functions of marketing, manufacturing, or



research and development or other functions that determine the success of the taxpayer's products. These personnel can be identified from several factors, such as experience, educational background, income, performance evaluation, and duties of the personnel; and

f) Existence of distribution channels and customer lists.

The contributions made by the taxpayer in connection with the success of its products should receive remuneration over and above the routine functions that are performed. Therefore, the reasonable range of the taxpayer's financial performance should be higher than the average for similar companies that do not have a contribution to intangible assets.

After performing the FAR analysis, the Revenue Officers should be able to draw conclusions about the characteristics of the taxpayer's business and the functions performed by its related parties, and to examine the appropriateness of the remuneration received by the taxpayer and its related parties to the functions performed, assets used, and risks borne by each party.

The conclusion about the characteristics of the taxpayer's business may be in the form of toll manufacturing, contract manufacturing, fully fledged manufacturing, fully fledged distributor, limited risk distributor, commissionaire, commission agent, service provider or others.

In cases where there are some changes or developments in the business activities that may re-characterize the taxpayer's business, the Revenue Officers shall determine the adjustments based on the functions performed, assets used, and risk borne.

2.) Selection of Transfer Pricing Method

In choosing the transfer pricing method (TPM), identifying the availability of comparables and determining the most appropriate transfer pricing method based on facts and condition are necessary.

a) Identify available comparables.

One of the important things in choosing TPM is the availability of reliable independent comparables. The purpose of this is to ensure availability and reliability of independent comparables to be applied. Comparables to be identified can be in the form of prices data (for example market prices for commodities), data on margin of gross profit, or data on margin of net profits. Comparables used to test transaction of the taxpayers with their related parties can be grouped into internal comparable and external comparable.



1) Internal comparables

Internal comparables are obtained when the tested party⁴ engages in sale transactions or purchases of goods/services with unrelated parties, licensing of Intangible property to unrelated parties, imposition of interest rates/ interest payments on loans to unrelated parties, etc. Factors that need to be confirmed in identifying reliable internal comparables include the following:

- a) Ensure that the internal comparables are not transactions that were performed solely to justify that the related party transactions are at arm's length.

Example 4:

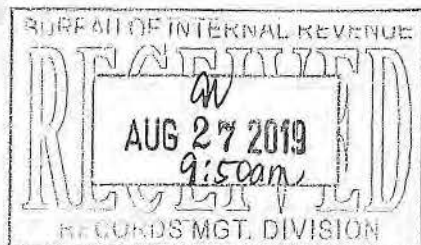
TMD Corp., a manufacturer of agricultural machinery, sells part of its product 3WG through LAC Inc., its subsidiary in country X. In addition, TMD Corp., also sells a small amount of its product 3WG to FEL Ltd., an independent distributor in country Y. The economic conditions in country X and country Y are relatively similar. To use the sale transactions to FEL Ltd. as internal comparables, it must first be confirmed that these independent transactions are not performed solely to justify that the affiliated transactions are at arm's length.

"Performed solely" means that FEL Ltd. is not economically dependent from its transaction with TMD Corp.

- b) Ensure that internal comparables are independent transactions performed in the normal course of business.

Example 5:

At the start of the year, TMD Corp., a manufacturer of agricultural machinery, sells product 3WG to LAC Inc., its subsidiary in country X. However, at the end of that year, TMD Corp. goes bankrupt and has to liquidate its inventory by selling all its product 3WG at a liquidation price. Because this liquidation sale is not conducted under normal business conditions, the sales of TMD Corp. at the time of the liquidation cannot be used as an independent comparable in determining the fair price of TMD Corp.'s products to LAC Inc.



⁴ 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. (RR No. 2-2013)

- c) Ensure comparability between the related party transactions and the internal comparables by considering the five (5) comparability factors as enumerated in RR No. 2-2013.



1. Characteristics of goods and services;
2. FAR analysis;
3. Contractual forms;
4. Economic circumstances; and
5. Business strategies.

2) External comparables

The external comparables that can be used to test the arm's length nature of related party transactions may be in the form of the following but not limited to:

- a) market price of commodity products or price of similar goods/services traded by unrelated parties, such as gold, silver, crude palm oil (CPO), coal, and other commodity products;
- b) Bangko Sentral ng Pilipinas Offered Rate (BSP);
- c) Philippine Securities and Exchange Commission (SEC) database; and
- d) commercial databases (i.e., orbis, oreana, onesource, speeda).

b) Choose the TPM that is Most Appropriate to the Facts and Conditions

Factors that need to be considered in selecting the TPM that is most appropriate to the facts and conditions include the following:

- 1) advantages and disadvantages of each method;
- 2) appropriateness of the TPM to the basic nature of the transaction, determined based on FAR analysis;
- 3) availability of reliable information (in connection with independent comparables) to apply the method that is chosen and/or other methods; and
- 4) level of comparability between the related party transaction and the transactions between independent parties, including reliability of

adjustments made to eliminate the material influence of any differences.

To choose the most appropriate method in a transfer pricing case, it needs information in respect of factors of comparability on related transactions in examination process, especially information on FAR of all related parties entering into transaction with taxpayer, including related party existing abroad.

Selection of tested party is carried on based on functional analysis already prepared and reliability of data/proofs/information as well as facts obtained in audit. The Revenue Officer can choose taxpayer which is being audited as tested party. The Revenue Officer can also choose counterpart of audited taxpayer as tested party.

Factors that require attention in choosing the tested party include the following:

- The tested party is generally the party that has the less complex functions, for example, the party that does not have unique/valuable intangible property;
- If the tested party is located abroad, the Revenue Officers should confirm the reliability of the information regarding the tested party, for example by requesting data/information on financial statements or other data from the taxpayer and/or performing an exchange of information with the competent authority in the country concerned.; and
- If the Revenue Officers cannot confirm the reliability and adequacy of information of a related party located abroad that was to be tested, the Revenue Officers can select the taxpayer or another related party as the tested party.

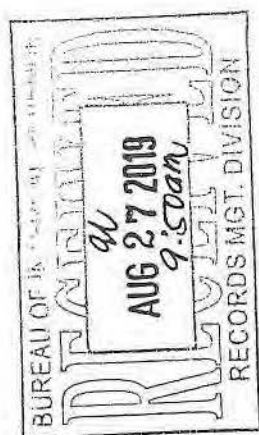
3.) Application of the Arm's Length Principle⁵ (ALP)

Applying the ALP is conducted after choosing the most appropriate TPM and should consider the following:

⁵ "Where

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly." (Article 9 Philippine Tax Treaties)



a. Performing Comparability Analysis

Audit on transfer pricing is made by comparing condition of related transactions and condition of independent transaction. Related transaction is deemed comparable with independent transaction in the event that:

- a.1 Difference (if any) between condition of affiliated transactions and condition of independent transaction has no material influence to prices or profits;
- a.2 Accurate reliable adjustment can be conducted to eliminate material influence.

b. Increasing Scope of Comparability

To compare condition in related transactions to condition of independent transaction, economically relevant characteristics of condition compared must be comparable adequately so that the comparison is more accurate. In the event that condition of related transactions is not comparable with condition of independent transaction, expansion of scope of comparability can be conducted by ways, among other things:

b.1 Criteria of Manual Searching and Selection

To generate reliable comparable, data searching in commercial database must use right searching strategy/searching criteria, among other things:

- b.1.1 Code of industry in accordance with the audited taxpayer;
- b.1.2 Region;
- b.1.3 Availability of data; and
- b.1.4 Indicator of financial statement.

Following the data searching through the searching strategy, one or more data of company to be made as comparable will be obtained. However, data obtained from commercial database only constitute candidate comparable. The candidate comparable chosen must undergo manual selection process (manual review/manual screening) that can be decided whether the candidate comparable is used (reliable) or rejected.

Manual selection is made by learning profile of every company becoming candidate comparable, seeing in its website, searching information relating to the candidate comparable in printed media or online or other methods.

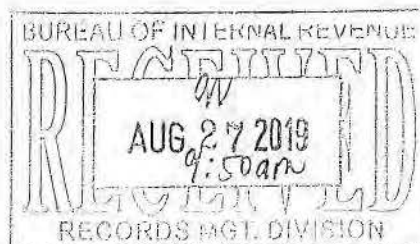


The criteria to reject candidate comparable, among other things, are as follows:

1) General Review

The purpose of the general review is to select companies that have data or information available to further testing and those that meet basic comparability requirements such as independence, product and business activity similarities. The Table below summarizes the general review.

Rejection Criteria	Description	Number of companies remaining after applying the criterion
Active	Reject companies that are no longer active or are dormant since they do not have economic activity	
Corporate Structure	Reject companies that are not listed as a stock corporation i.e. the companies' legal form is either a limited or general partnership.	
Available information	Reject companies that do not have financial information for at least 2 of the 3 years of the tested period. Reject companies that do not have sufficient information based on internet research.	
Product and business activity	Review the main business activity of the companies and the products that they deal with.	

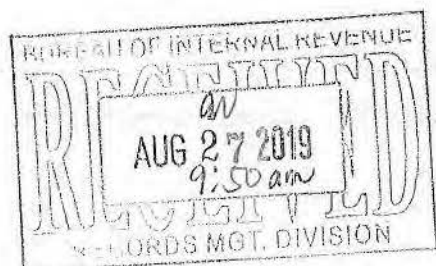


Independence	Reject companies that have the following: (a) Companies which are owned by another by more than 25% of its total shareholding; or (b) Companies which have related party transactions that are more than 20% of the relevant threshold.	
Consecutive losses	Reject companies that are not comparable due to the volatility of their profitability as evidenced or shown by consecutive years of losses incurred.	
Other rejection reason	Reject companies that declared affidavit of non-operation and discontinued commercial operations, newly registered companies, companies that have no business description or have insufficient data.	

2) Financial Review

The financial information of the remaining companies is placed under further scrutiny to ensure that the companies perform the same FAR. The table below summarizes the steps below.

Rejection Criteria	Description	Number of companies remaining after applying the criterion
Level of revenue	Reject companies whose revenue level exceeds 10 times higher or lower than the tested revenue level, indicating the company's scale of operations may be different from the tested party.	



Level of research and development expenses	Reject companies whose ratio of research and development expenses to sales exceed 3%	
Level of intangible assets to total assets	Reject companies whose ratio of intangible assets to total assets exceed 3%.	

b.2 Use of Multiple Year Data

To obtain a complete understanding of the facts and circumstances surrounding a controlled transaction⁶, it is useful to examine from both the years after the year under examination and prior years. The use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, a result of a particular economic condition in a prior year that caused an increase in cost in the subsequent year, or a reflection of the fact that a product is at the end of its life cycle.

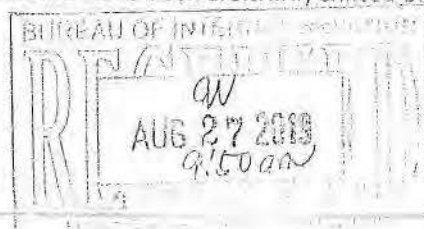
b.3 Use of an Interquartile Range⁷

In some case it will be possible to apply the arm's length principle to arrive at a single figure (e.g. price or margin) that is the most reliable to establish whether the conditions of a transaction are at arm's length. However, because transfer pricing is not an exact science, there will be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable. This is often the case in practice where the comparables are extracted from a database. In such cases, if the range includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis.

The end result of the financial data analysis after performing FAR of the selected comparables are summarized in an interquartile range. The median is the midpoint of the interquartile range. The median will generally produce a different result to the average of the range being considered.

⁶ Controlled transaction means any transaction between two or more associated enterprises. 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.

⁷ Paragraph 3.57 of the OECD Guidelines



In these cases, differences in the figures that comprise the range may be caused by the fact that in general the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises. It is also possible that the different points in a range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction.

It may also be the case that, while every effort has been made to exclude points that have a lesser degree of comparability, what is arrived at is a range of figures for which it is considered, given the process used for selecting comparables and limitations in information available on comparables, that some comparability defects remain that cannot be identified and/or quantified, and are therefore not adjusted.

If the relevant conditions of the controlled transactions (e.g. price or margin) are within the arm's length range, no adjustment should be made.

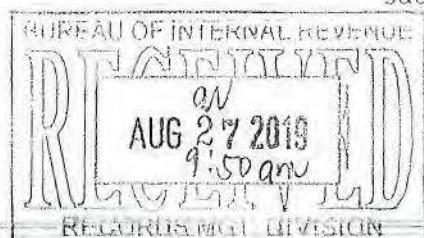
If the relevant conditions of the controlled transaction (e.g. price or margin) fall outside the arm's length range asserted by the BIR, the taxpayer should have the opportunity to present arguments that the conditions of the controlled transaction satisfy the arm's length principle, and that the result falls within the arm's length range (i.e. that the arm's length range is different from the one asserted by the BIR). 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 conditions of the controlled transaction.

b.4 Comparability Adjustment

Measures on comparability adjustment are taken if there is difference of conditions that influence condition (prices or profits) materially between related transactions and independent transaction. Comparability adjustment can be in the form of adjustment of difference of contractual terms, etc.

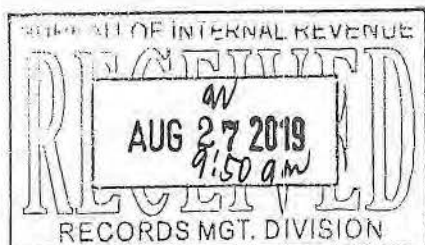
If reasonably accurate adjustment cannot be done, then test of ALP at related transactions should be conducted by using other TPM that is most appropriate with facts and conditions.

Where the Revenue Officer has found that a price in a controlled transaction is not at arm's length, he may make an adjustment to reflect the arm's length price or interest rate for that transaction by substituting or imputing the price, or interest, as the case may be. In such instances, the adjustment will also be reflected by a



corresponding adjustment upon request of the other party of the controlled transactions. Adjustments will be made where:

- 1) For the supply of property/goods or services, the consideration is less than the consideration that would have been received or receivable in an arm's length arrangement;
- 2) For the acquisition of property/goods or services, the consideration is more than the consideration that would have been given or agreed to be given in an arm's length arrangement; or
- 3) No consideration has been charged to the related/associated party for the supply or services.



b.5 Losses

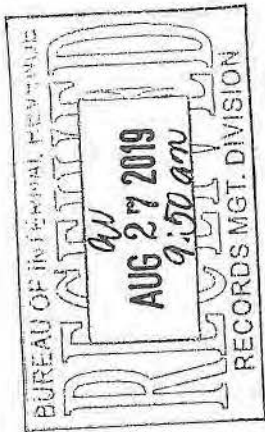
Companies incur losses for variety of economic and business reasons such as startup losses, market penetration strategies, and research and development failure. However, an independent company would not endure continuous losses without taking appropriate measures to correct the situation within reasonable time, as it would contradict fundamental business objectives of making profits. The fact that related/associated company continuously suffers losses may be an indication that it is not being compensated fairly.

In determining whether the losses are acceptable, it is important to ensure that the controlled transaction entered into is commercially realistic and make economic sense. A taxpayer needs to establish that the losses are commercial in nature within the context of its characterization. In this regard, a taxpayer is expected to maintain contemporaneous documentation which outlines the non-transfer pricing factors that have contributed to the losses.

A contract or toll manufacturer that only carries out production as ordered by a related party, without performing functions such as operational strategy setting, product R&D and sales, is expected to maintain a consistent level of profitability. Should the manufacturer suffer from losses, it must prove that these losses are not a result of its transactions with a related party.

b.6 Separate and Combined Transactions Approach

To obtain the most precise approximation of arm's length price or profit allocation, the ALP should ideally be applied on a transaction-by-transaction basis. However, depending on the circumstances of the case, transfer pricing may sometimes need to be dealt with at the level of a product or business unit rather than at the level of each particular transaction.



In establishing transfer prices, taxpayers should set prices separately for each transaction they enter into with a related/associated person. However, where transactions are so closely linked (or continuous) that they cannot be evaluated adequately on a separate basis, determination of transfer price based on bundled transactions may be considered. This is provided if it can be demonstrated that it is the normal industry practice to set one price for a combination of transactions (e.g. goods and the associated intangible property) or where it may not be reasonable to expect to find quality data available to set the price for separate transactions. Lack of reliable data on comparable transactions may be due to the complexity of the dealings or the relationships between the parties. Therefore, the total amount may be on an aggregate basis.

It is generally accepted to group intangible associated with the product or service provided if comparable independent transactions also have these various transactions which cannot be disaggregated and are bundled into a package deal with all the associated costs being included in the price of the product.

Example 6:

Aggregation of transaction involving tangible and intangible products that are highly integrated

A company that licenses a manufacturing know-how and supplies vital components that are highly integrated to a related/associated party may find it more reasonable to assess the arm's length price for these two activities as an item instead of separately.

Example 7:

Aggregation of transactions where one product complements the other

Aggregation of transactions may also be appropriate in situations where a taxpayer is required to carry an unprofitable product or line of products which are auxiliary to the profitable items and where there is sufficient profit available to provide an adequate return from the complete product range to reward the FAR of the company. Common types of bundled products that fall under this category include printers with cartridges, and razors with blade.

Example 8:

Disaggregation of transactions where the nature of transactions is substantially different.

Company LAC was established in the Philippines to handle distribution, sales, after-sales service, repair, and maintenance services of the TMD



group vehicles consisting of trucks, buses and coaches which are 100% imported from its parent company in the US. Company LAC is also the regional hub for TMD in South East Asia, covering markets such as Singapore, Thailand, Vietnam and Malaysia. This regional office also houses the regional training center where mechanics, technicians, driver trainers and managers from Asia Pacific region are trained to provide TMD's group customers in the region.

Ordinarily, in this situation, the various kinds of activities should not be aggregated and Company LAC is required to prepare segmental accounts as follows, in order to enable the evaluation of the arm's length nature of the controlled transactions on a transactional basis:

- Sales and distribution
- Repair and maintenance services
- Regional service

b.7 Re-Characterization of Transactions

Examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the taxpayer insofar as they are consistent with the methods described in the Guidelines. However, when reviewing an agreement between related/associated parties, consideration is not only on the terms of the agreement but also the actual conduct of the parties.

Therefore, in determining an arm's length price, the Revenue Officer may disregard and re-characterize a controlled transaction under the following circumstances:

- (a) Where the economic substance of a transaction differs from its form; or
- (b) Where the form and substance of a transaction are the same, the arrangements made in relation to the transaction when viewed in their totality, differ from those which would have been adopted by independent persons behaving in commercially rational manner and this actual structure practically impedes the BIR from determining an appropriate transfer price.

The need to re-characterize a transaction is based on the rationale that the character of the transactions is derived from the relationship between the parties and is not determined by normal conditions. The controlled transaction may have been structured by the taxpayer to avoid or minimize tax. This is supported by the fact that –



- (a) Related/associated parties are able to enter into a greater variety of contracts and agreements compared to independent persons because the normal conflict of interest which exist between independent parties is often absent;
- (b) Associated persons often conclude arrangements of a specific nature that are not, or very rarely, encountered between independent persons; and
- (c) Contracts under a controlled transaction are quite easily altered, suspended, extended, or terminated according to the overall strategies of the multinational group as a whole and such alteration may even be made retroactively.

Example 9:

An investment in a related/associated company in the form of interest-bearing debt would not be expected to be structured in the same way had it been conducted at arm's length, given the economic circumstances of the borrowing company. In this case, it might be appropriate for a tax administration to characterize the investment in accordance with its economic substance where the loan may be treated as subscription of capital.

Example 10:

A sale under a long term contract, for a lump sum payment, gives unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract. While it may be proper to respect the transaction as a transfer of commercial property it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in its entirety to that which might reasonably have been expected between independent persons. Thus, in the case described above, it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rationale manner as a continuing research agreement.

C. REPORTING OF AUDIT ON TRANSFER PRICING

The report should include the following:

- Executive Summary
- Factual Background and Functional Analysis of the Taxpayer and the Transaction(s) at Issue

- Summary of Taxpayer's Proposed Economic Analysis for the Transaction at Issue
- Critique Taxpayer's Methodology and Analysis for the Transaction at Issue
- Revenue Officer's Determination of Arm's Length Price based Upon Economic Analysis
- Summary and Conclusion

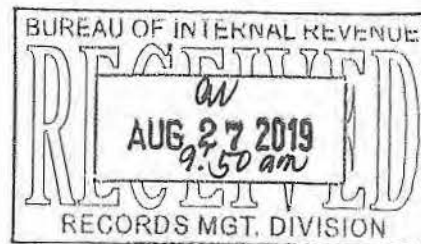
The Revenue Officers shall meet with the taxpayer to discuss the audit findings on all issues prior to finalizing the report. Discussions are to focus on:

- Understanding the taxpayer's position
- Determining whether the taxpayer agrees with the facts
- Determining whether the taxpayer would agree to any issues



CHAPTER III

Transfer Pricing Audit Method



Audit of transfer pricing on taxpayer's transaction with their related/associated parties can be conducted by performing test of prices or profits whether at level of gross profit or at level of net operating income. After making comparability analysis, test of application of ALP is performed by applying TPM.

Transactions of Sale or Purchase of Goods/services

To test sales or purchases of goods/services, the Revenue Officers can use the TPM that is most appropriate to the facts and conditions. Below is a description of the steps to apply the arm's length principle in accordance with the method that was chosen.

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. Any difference between the two prices may indicate that the conditions of the commercial and financial relations of the associated enterprises⁸ 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 CUP method is applied by comparing the prices of goods or services in related party transactions with the prices of goods or services in independent transactions. Application of the CUP method to transactions of sale or purchase of goods/services is done using the following steps:

(a) Perform Comparability Analysis

Before price comparison is done, the Revenue Officers must first confirm the comparability between the related party transactions and independent transactions. Below is an explanation of the comparability factors that must be noted in testing related party transactions using the CUP method.

(i) Characteristics of the Goods and Services

In performing the comparability analysis, it must be understood that *minor differences in the characteristics of goods and services* can have a material influence on the price of the goods and services. Therefore, the comparability of the goods or services is an important factor that needs to be considered in

⁸ 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.

the CUP method compared with the application of other TPMs.

(ii) FAR Analysis



In addition to the characteristics of the goods and services, comparability of the functions performed, assets used and risks involved between the related transactions and the independent transactions has also material influence on the price of goods and services. Generally, significant differences in function, assets, and risks will reflect a difference in the expected return.

Aside from the characteristics of the products and the FAR analysis, differences in contractual terms, business strategy, and economic conditions are also important comparability factors that need to be considered when applying the CUP method.

After performing comparability analysis, comparison of the prices of goods or services in related party transactions and the prices of goods or services in independent transactions can be done. There are two ways to compare prices of goods or services which are direct and indirect comparison:

- (a) Direct comparison is done if there are no differences in conditions between the related party transactions and independent transactions that materially influence the prices of the goods and services, so adjustments can be made directly for any differences in the prices of the goods and services.
- (b) Indirect comparison is done if there are differences in conditions between the related party transactions and the independent transactions that materially influence the price of the goods and services, and reasonably accurate adjustments can be made to eliminate this material influence.

(b) Increase Comparability

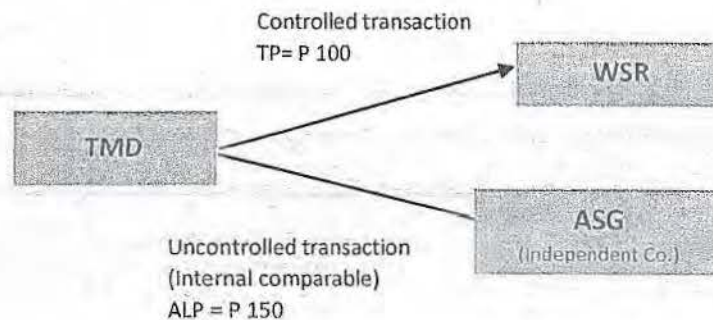
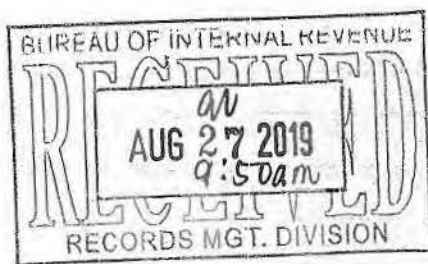
Increasing comparability is done when there are differences in conditions between related party transactions and independent transactions that materially influence the prices of the goods and services. The purpose of increasing comparability is to eliminate that material influence.

Increasing comparability in the CUP method is done by making reasonably accurate adjustments for the differences in conditions

between the related party transactions and the independent transactions.

Example 11:

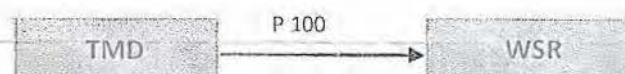
Taxpayer TMD, a MNE, sells 60% of its product to an associated company WSR, at a price of P 100 per unit. At the same time, the remaining 40% is sold to an independent enterprise ASG at P 150 per unit.



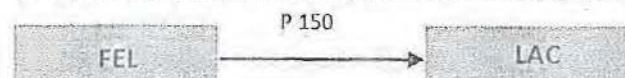
The products sold to WSR and ASG are the same, and the transaction between TMD and ASG may be considered as a comparable uncontrolled transaction. However, FAR of WSR and ASG must first be carried out to determine any differences. If there are differences, adjustments must be made to account for these differences. Adjustments must also be made to account for product quantity discounts since volume of sales to WSR and ASG are different. Assuming there are no material differences that require adjustments to be made, the CUP may be applied using the unit price of P 150 as a comparable arm's length price.

Example 12:

Controlled transaction



Uncontrolled transaction (External comparable)



Manufacturer TMD exports its product to associate company WSR. Manufacturer FEL exports the same product, in similar quantities and under similar terms to company LAC, an independent party operating in similar markets as WSR. The uncontrolled sales price is a delivered price whereas the controlled sales are made FOB factory. These

differences in terms of transportation and duties have an effect on price. Therefore, adjustments should be made on the uncontrolled transaction to eliminate the differences.

Selling Price FEL to LAC		P 150
Less:		
Adjustment for freight	P 10	
Adjustment for duties	5	
Total adjustments		(15)
Arm's length price TMD to WSR		P 135

2) 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.

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.

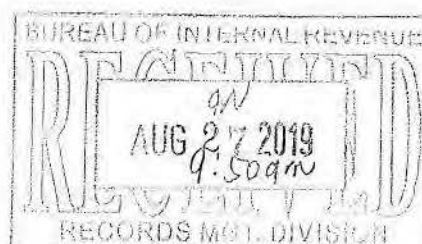
The resale price method is a transfer pricing method that determines the purchase price of goods from related parties by deducting the gross profit of comparable independent parties from the resale price of the goods to the independent parties. Application of the Resale Price Method in transactions of purchase of goods is done through the following steps:

a). Perform Comparability Analysis

In applying the Resale Price Method, attention must be given to the comparability factors between the related party transactions and the independent transactions, including the following:

(i) Characteristics of Goods

In applying the resale price method, differences in the characteristics of goods generally do not have a material influence on the gross margin.





Example 13:

A company that distributes toasters and a company that distributes blenders have comparable FAR, so these two distributor companies should have comparable levels of gross margin for their sales of toasters and blenders.

In applying the resale price method, although differences in the goods can be tolerated, the comparability of the characteristics of goods must still be considered. Extreme differences in the characteristics of goods tend to indicate the existence of differences in FAR which have a material influence on the gross margin.

(ii) FAR Analysis

In the resale price method, comparability of the FAR between the related party transactions and the independent transactions receives a greater emphasis than the comparability of the characteristics of goods. Related party transactions and independent transactions can be considered non-comparable when there are significant differences in FAR. Generally, significant differences in FAR reflect differences in the expected return.

(iii) Consistency of Accounting Standards

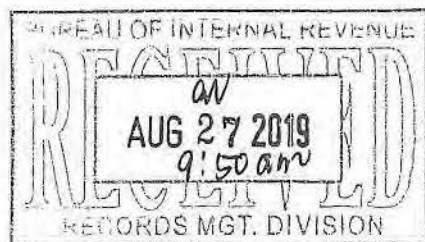
Another important matter in applying the resale price method is consistency of the accounting standards between the related party transactions and the independent transactions. Among the aspects of consistency of accounting standards that need to be noted is uniformity in classification of expenses.

(iv) No Significant Added Value to the Product

Generally, this method will be more appropriate to use if the reseller does not add any significant value to the products that are sold.

(v) Intangible Assets That May Be Generated

If a distributor performs extensive marketing activities (for example, creation of distribution channels or very high promotion/advertising expenses), it can be said that the distributor may have become the economic owner of intangible assets (economic ownership) in connection with the extensive



(vi)

marketing activities. Generally, this method will be more appropriate to use if the distributor does not engage in extensive marketing activities.

Existence of Exclusive Rights

If a distributor obtains exclusive rights for selling the goods, this can influence the gross margin. These exclusive rights are influenced by several factors, such as size of the territory and existence of competitors. Generally, this method will be more appropriate to use if the distributor does not have exclusive rights.

(vii)

Other Comparability Factors

Differences in contractual terms, business strategy, and economic conditions are also important comparability factors in applying the resale price method. After performing the comparability analysis, the Revenue Officers compare the gross margin of the related party transactions with the gross margin of the independent transactions. There are two ways to compare gross margin:

(a) Direct comparison: if, based on the comparability analysis, there are no differences in conditions between the related party transactions and the independent transactions that materially influence the gross margin, the arm's length purchase price can be determined from the difference in gross margin. Adjustments are then made for the difference between the fair purchase price and the purchase price with related parties.

(b) Indirect comparison is done when, based on the comparability analysis, there are differences in conditions between the related party transactions and the independent transactions that materially influence gross margin, so reasonably accurate adjustments are made to eliminate this material influence in conditions in order to derive the reasonable purchase price.

b) Increase Comparability

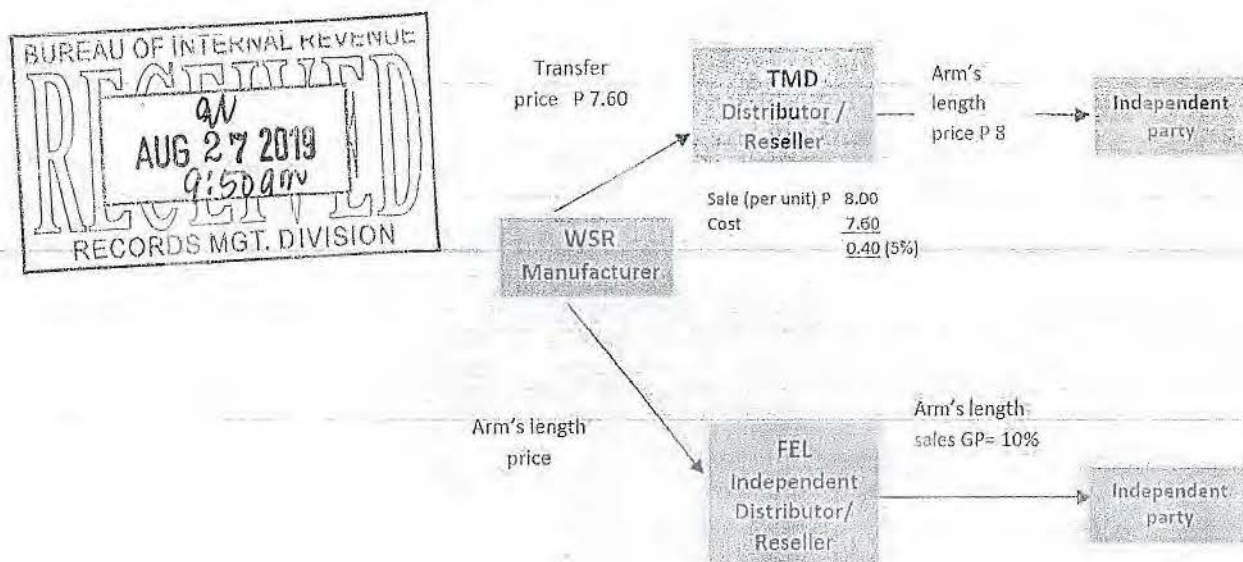
Increasing comparability is done when there are differences in conditions between related party transactions and independent transactions that

materially influence the gross margin. The purpose of increasing comparability is to eliminate this material influence on the gross margin. Comparability can be increased by making reasonably accurate adjustments, using multiple-year data, aggregating transactions, and using manual search and selection criteria.

If it is difficult to make reasonably accurate adjustments, the Revenue Officers need to consider using another transfer pricing method that is more appropriate to the facts and conditions.

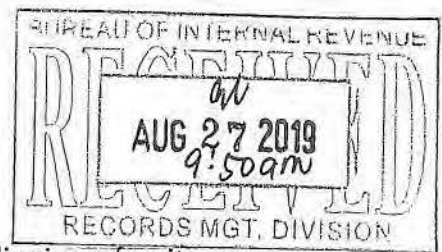
Example 14:

Taxpayer TMD, a distributor, is a Philippine subsidiary of multinational WSR, which is located overseas. WSR distributes high quality product manufactured by WSR. WSR also sells similar product of a lower quality to an independent distributor FEL in Philippines. The cost of product purchased from WSR by TMD is P 7.60 per unit. TMD resells the product to independent party for P 8.00. A functional analysis shows that TMD and FEL perform similar function. The gross profit ratio of FEL was found to be 10%.



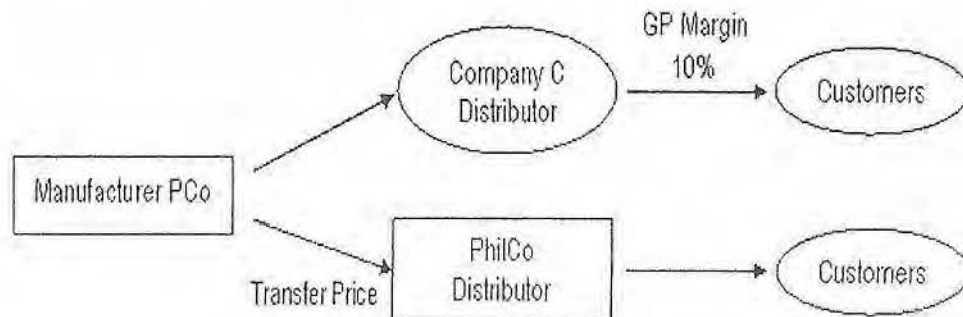
In this example, it is noted that there are product (quality) differences when comparing the controlled and uncontrolled transactions. However, since the focus of comparison is on margins, the differences are not as material as they would have been if the basis of the comparison were on the prices. Furthermore, TMD and FEL carry out similar functions (FEL being another reseller in the same market), thus the resale price margin of 10% will be used as basis to determine the arm's length price for the original purchase by TMD from WSR.

Arm's length price of product purchased (in Php) = $8 - (8 \times 10\%) = \text{P } 7.20$



Example 15:

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 in the 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)	<u>P3,070</u>

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.

3) 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.

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 Plus Method is a transfer pricing method that adds the gross profit from comparable independent transactions to the costs borne in related party transactions. Application of the cost plus Method to transactions of sales of goods/services is done using the following steps:

a) Perform Comparability Analysis

In applying the cost plus method, attention must be given to the comparability factors between related party transactions and independent transactions, including the following:

(i) Characteristics of Goods and services

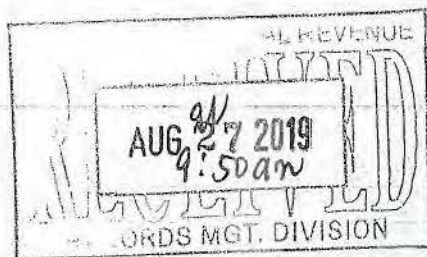
In the cost plus method, differences in the characteristics of goods and services generally do not have a material influence on the gross mark-up.

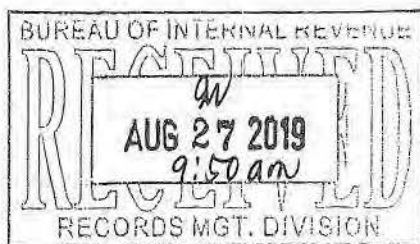
Example 16:

A company manufacturing toasters and a company manufacturing irons have comparable FAR, so these two manufacturing companies should have comparable levels of gross mark-up. Comparison of the toaster manufacturer and the iron manufacturer is done on the assumption that there is no reliable toaster manufacturer. Although differences in goods or services can be tolerated, the comparability of the characteristics of goods and services between the related party transactions and the independent transactions still requires attention. Excessive differences in the characteristics of goods and services tend to indicate the existence of differences in FAR that have a material influence on the mark-up.

(ii) FAR Analysis

In the Cost Plus Method, comparability of FAR between related party transactions and independent transactions is emphasized more than comparability of the characteristics of goods and





services. Related party transactions and independent transactions can be considered non-comparable if there are significant differences in FAR. Generally, significant differences in risks reflect differences in the expected return.

Example 17:

After performing FAR analysis, when engaging in transactions with its parent company that owns intangible assets, TMD Corp. functions as a manufacturer with limited functions and risks (contract manufacturing) that does not bear market risk, while when engaging in transactions with unrelated parties, TMD Corp. functions as a fully-fledged manufacturer that bears market risk. In this case, there are differences in FAR and expected return between the affiliated transactions and the independent transactions that have a material influence on the gross markup.

In this scenario, independent transaction of TMD Corp. cannot be used as internal comparable because of the material differences in its functions and risks.

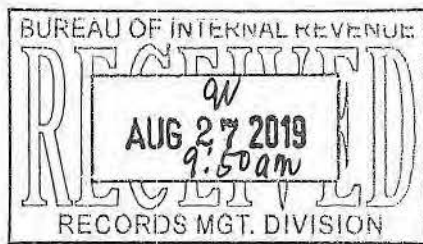
(iii) Consistency of Accounting Standards

Another important aspect in the use of the cost plus method is that the gross mark-ups that are compared have a connection with the cost base, so when testing related party transactions using the cost plus method, the Revenue Officers need to confirm the comparability of the cost bases. With regard to the cost base, consistency of cost structure is an important aspect. There may be differences in accounting treatment between countries, and even between companies in the same country.

(iv) Other Comparability Factors

Differences in contractual terms, business strategy, and economic conditions are also important comparability factors in applying the cost plus method. The Revenue Officers compare the gross mark-up of related party transactions and the gross mark-up of independent transactions after performing comparability analysis. There are two ways to compare gross mark-up:

- (1) Direct comparison: if the comparability analysis does not find differences in conditions between the related party transactions and the independent transactions that materially influence the gross



mark-up, the reasonable price can be determined from the difference in gross mark-up and adjustments can be made on the difference between the reasonable selling price and the selling price from related parties.

- (2) Indirect comparison is used when, based on the comparability analysis, there are differences in the conditions between the related party transactions and the independent transactions that materially influence the gross mark-up, and so reasonably accurate adjustments are made to eliminate this material influence in order to obtain the reasonable selling price.

b) Increasing comparability

Increasing comparability is done when there are differences in the conditions between related party transactions and independent transactions that materially influence the gross mark-up. The purpose of increasing comparability is to eliminate this material influence on the gross mark-up. Increasing comparability in the cost plus method is generally done by making reasonably accurate adjustments, using multiple-year data, aggregating transactions, and using manual search and selection criteria.

4) 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.

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.

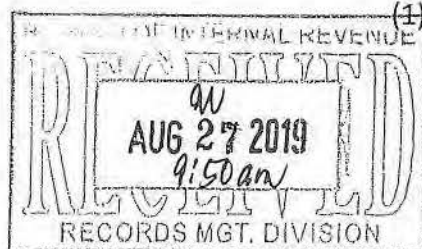
The Transactional Net Margin Method is a transfer pricing method that uses the indicator of profit level in comparable independent transactions to determine the net operating profit of related party transactions. Application of the Transactional Net Margin Method in transactions of purchase/sale of tangible goods and services are done using the following steps:

- a) Select the Profit Level Indicator (PLI) that is most appropriate to the facts and conditions.

The PLI is shown in the form of a ratio between net operating profit and sales, total costs, assets, etc.

Determination of the denominator used in the TNMM is done by considering the company's profit drivers and their independence from the denominator that is used. Other factors that need to be considered in selecting the PLI are the type of business and the availability of data. Service provider companies, manufacturers and the like generally use net operating profit compared with total cost as the PLI. In contrast, distribution activities generally use net operating profit compared with sales.

The ratios generally used as PLI are net margin, net markup, and return on assets (ROA).



(1) Ratio of Level of Return on Sales (Net Margin)

Net Margin is calculated using the following formula:

$$\text{Net Margin} = \frac{\text{Net Operating Profit}}{\text{Sales}} \times 100\%$$

(2) Ratio of Level of Return on Total Costs (Net Mark-up)

Net Mark-up is calculated using the following formula:

$$\text{Net Mark-up} = \frac{\text{Net Operating Profit}}{\text{COGS} + \text{Operating Costs}} \times 100\%$$

(3) Ratio of Return on Assets (ROA)

ROA is calculated using the following formulas:

$$\text{ROA} = \frac{\text{Net Operating Profit}}{\text{Total Operating Assets}} \times 100\%$$

$$\text{ROA} = \frac{\text{Net Operating Profit}}{\text{Total Assets} - \text{Non-Operating Assets Including Cash}} \times 100\%$$

Total operating assets include operating fixed assets (including land, buildings, plant and equipment), intangible assets used in the business (such as patents or know-how), and working capital assets (such as inventory and trade receivables less trade payables). Investments and cash are not included in operating assets unless the company operates in the financial services industry.

a) Increase Comparability

Increasing comparability in the TNMM includes:

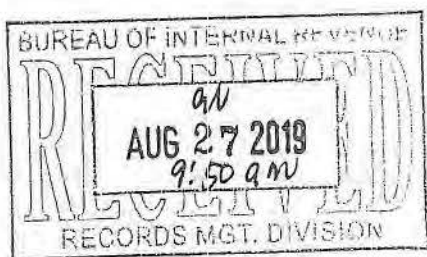
(1) Manual Search and Selection Criteria



When the comparable companies used are external comparables, the search for comparables can be done using publicly available data, such as commercial databases. Searching using a commercial database can be done through a search using certain specific criteria (a searching strategy), such as an industry code in accordance with the Taxpayer being audited, region, availability of data, and financial statement indicators.

After conducting a data search using a particular searching strategy, data on one or more companies will be obtained that can be used as comparables. However, the data obtained from a commercial database are only candidate comparables. The candidate comparables that have been selected must then undergo a process of manual review/manual screening so that it can be decided whether the candidate comparables are used (reliable) or rejected.

This manual screening can be done by studying the profiles of the companies that are candidate comparables, looking at their websites, seeking information about the candidate comparables from print or media online, or other methods. Manual screening can be done quantitatively and qualitatively.



(2) Use of Multiple-Year Data

Multiple-year data are used when they can improve the results of the comparability analysis. Analysis of multiple-year data can improve the process of screening of candidate comparables, for example by identifying comparables with significant differences from the tested party. In certain cases, this can lead to rejection of a candidate comparable or the detection of anomalies in candidate comparables. The use of multiple-year data in comparability analysis does not mean that the determination of the fair price or profit uses the average performance of multiple-year data.

(3) Per Transaction or Combined Transaction Approach

Testing of related party transactions can be done per transaction or by combining transactions, considering the facts and conditions. Testing of combined related party transactions is more appropriate, for example, when the transactions are closely linked or continuous. Examples of application of testing of combined transactions:

- (a) Transactions arising from a long-term contract for supply of commodities or services;
- (b) Use of intangible property intrinsic in a product;
- (c) Determination of prices of closely linked products; and
- (d) The company applies a pricing strategy focused on a portfolio approach by minimizing the profit from certain products in order to maximize the profit on other related products, for example the pricing of printers and of cartridges.

5) Profit Split Method (PSM)

The PSM is a transfer pricing method that splits the combined profit between the related parties involved in related party transactions based on the contributions they make. The profit split method is used in cases involving highly integrated

operations or where both parties make a unique and highly valuable contribution (for example, contribution of unique/valuable intangible properly) so that the testing cannot be done separately.

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.

Two profit split methods are commonly used: The Contribution Profit Split Method and the Residual Profit Split Method.

Below are the techniques for testing the reasonableness of transactions using these methods.

a) Contribution Profit Split Method

The Contribution Profit Split Method is applied when transactions occur between parties that are closely integrated. This method is also known as one-stage analysis.

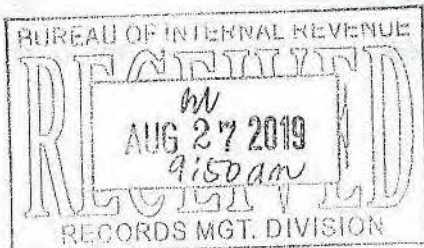
The steps in applying the Contribution Profit Split Method include the following:

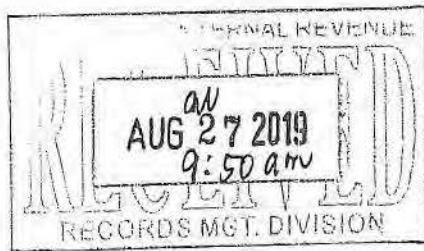
- (1) Combine the net operating profit of the parties as a single unit.
- (2) Determine the FAR that contribute to the net operating profit.
- (3) Identify external data.

Before performing the weighing of the functions, the Revenue Officers can performance analysis of external market data (for example, from joint ventures) that reflects how independent parties allocate profit in comparable conditions. If no data are available; the Revenue Officers may use internal data (including financial data) to perform the weighing. Analysis of contributions is done based on a detailed analysis of whether the FAR that are used in allocating profit are economically acceptable/ justified.

- (4) Perform Weighing of Functions and Determine Percentage Shares of Profit.

The weighing is based on the relative values of the functions performed and the economic contributions of each of the affiliated parties in the transactions. The relative values of the





functions performed may be associated with costs expended, assets used, etc.

- (5) Allocate profit in accordance with the weight of the contribution of each affiliated party.

After obtaining the percentages of profit, next perform a calculation of the allocation of the profit to each of the related parties in the transactions based on the weight of their contributions.

- (6) Determine arm's length profit.

The positive correction to net operating profit is attributed to the affiliated transactions that occurred, such as purchase transactions.

6) Residual Profit Split Method (RPSM)

The RPSM is applied in cases where both parties in the transactions have unique and highly valuable contributions (for example, contribution of unique/valuable intangible property).

The steps in applying the Residual Profit Split Method include the following:

- (1) Combine the net operating profit of the related parties as a single unit.
- (2) Determine the contribution of each party.

Based on the FAR analysis, it is known that TMD Corp. has manufacturing intangibles in the form of patent, while TMDI has marketing intangibles.

- (3) Identify the routine functions (simple functions) without the contribution of each party.

TMD Corp. has a routine manufacturing function, while TMDI has a routine function as distributor.

- (4) Seek comparables for the routine functions without the unique contributions.

Based on the routine functions performed by each party, it is possible to determine comparables for these routine functions. The routine function of TMD is manufacturing, so the Revenue Officers need to seek comparable companies that routinely engage in

manufacturing. For PT TMDI, the Revenue Officers need to seek comparable companies that function routinely as distributors.

- (5) Calculate share of profit for each party without the unique contributions.

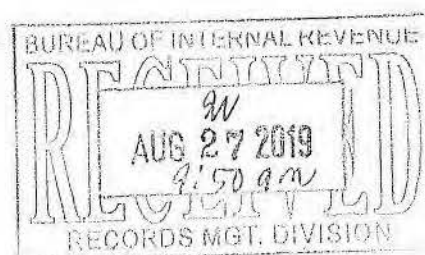
After obtaining external comparables for the routine functions of each party, the next step is to allocate the profit based on routine compensation using the one-sided method.

- (6) Determine the Relative Values of the unique contributions of each party.

The residual profit (that is, the remaining profit after step five (5) is attributed to the affiliated parties based on the relative values of the unique contributions made by each party.

The following approaches can serve as a basis in determining the relative values of the unique contributions of the related parties:

- (a) external market benchmark that reflects the fair market value of intangible property;
 - (b) capitalized costs for development, repair, and renovation of intangible property, less the appropriate amount of amortization based on the useful life of each intangible property; or
 - (c) actual amount of cost of development of intangible property in the most recent years, if this expense is constant during that period and the useful life of the intangible property of the parties involved does not differ too greatly.
- (7) Allocate the Residual Profit based on the relative values of the unique contributions of each party. After obtaining the relative values of the unique contributions of each party, the next step is to allocate the residual profit based on the relative values of the unique contributions of each party.
 - (8) Determine arm's length profit from the result of the calculations up to step seven (7) above.

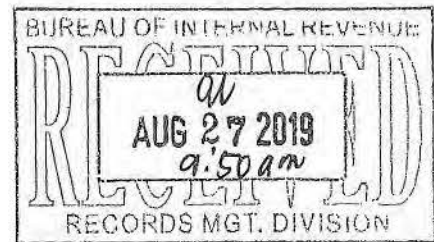


CHAPTER IV

Business Restructuring

Business restructuring within a multinational group often result in a change of business characterization and reduction of profitability of a local entity. Such reduction of profits is acceptable only with reduced functions performed, assets employed and risk assumed. As long as these FAR are actually transferred, it is viewed as commercially rational for a multinational group to restructure in order to obtain tax savings. However, if it is found that the local entity continues to perform the same functions, and bears the same risks, Revenue Officers will make necessary adjustments. In an arm's length situation, an independent party would not restructure its business if it results negatively for it, where it has option realistically available not to do so.





CHAPTER V

Intra-Group Services

Intra-group services are activities provided by one party within a business group that provide benefits for one or more other members in the business group. Intra-group services may take the form of management services, administration services, technical services, support services, purchasing services, marketing services, distribution services, and other commercial services provided in connection with the nature of the group's business.

Basically, the existence of transactions of delivery of intra-group services is recognized if the service provides economic benefit or commercial value that improves the commercial position of the company receiving the services (for example, increases profit or adds efficiency by reducing operating costs). This can be determined by considering whether an independent party in comparable conditions would be willing to pay an independent party or would perform the provision of the services itself (in-house).

Steps in Applying the Arm's Length Principle to Intra-Group Services:

- 1) Ensure that a certain service from a related party has in fact been performed and provided economic benefit to the other related party which can be tested by the Revenue Officer as follows:
 - a) To confirm the existence or realization of the service provided, the Revenue Officers need to consider the following:
 - Examine the process of the background for the need of the service and the related documents.
 - Examine the process of appointment of the service provider, including by examining the qualifications of the service provider (for example, as indicated by a curriculum vitae containing work experience, educational background, and the track record of the service provider).
 - Examine the process of negotiation regarding the compensation for the service that is provided.
 - Examine the process and results of the provision of the service as well as the related documents/ evidence.
 - Examine whether the actual service is rendered as defined under the service agreement.
 - Review documents relating to the service activities, such as contract agreements and invoices.

- Examine the parties involved in implementation of provision of the service (provision of services may be done by the related party itself or with the involvement of the taxpayer and third parties).
- b) To ensure that the service provided has an economic benefit, the Revenue Officers need to consider the following:
- Ensure that the functions performed by the taxpayer are matched with the type of intra-group services received.

Example 18:

Based on the result of the FAR analysis, it is known that PT ASG is a distributor that does not perform activities that add value to the products. Therefore, PT ASG should not be charged a fee for technical services related to manufacturing activities.

- Examine the details of the services charged (if more than one) and understand specifically how these services could provide or have provided economic benefit to the taxpayer.
- The following type of activities are not considered as intra-group services:

(1) Shareholder activity

Shareholder activity is services intended for activities of the parent company.

In certain conditions, a parent company will charge a service fee to its subsidiary even though the subsidiary does not need the service and would not pay for the service if there were no special relationship. Therefore, the amount charged as service fee is not allowed as a deduction.

Example 19:

- (a) Activities for the reporting needs of the parent company, for instance, preparation of consolidated financial statements.



(b) Activities related to the legal status and structure of the parent company, such as overseeing compliance of annual reports, holding shareholder meetings, issuing shares and managed by the oversight board.

(c) Collecting funds to be used by the parent company itself in order to acquire another business/branch.

(2) Duplicative services

Duplicative services are services performed by a member of a multinational corporation group that duplicate activities performed by the taxpayer itself or performed by a third party.

In evaluating the duplication of services, it is necessary to examine the taxpayer's ability to provide the service by itself (for example in terms of qualifications, expertise, and availability of personnel) or if the taxpayer has paid an independent party to provide the service. If a fee is charged for a duplicative service, this intra-group service cannot be charged.

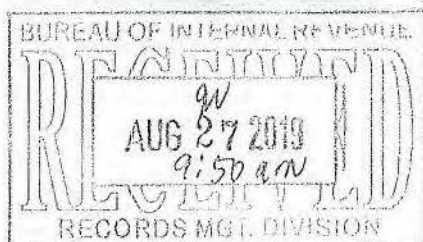
Example 20:

PT TMD has performed its own analysis of its operating capital and budget, but in the same year the parent company also charges PT TMD a fee for the same service of analysis of operating capital and budget.

An exception may apply if the duplication of services is only special and temporary.

(3) Services that provide incidental benefit

A service that provides incidental benefit is an activity performed by one member of a business group for certain members that also provides incidental benefit to the taxpayer in the group. Generally, intra-group services will be performed to meet the needs of a



particular beneficiary. Other members of the group may gain benefit incidentally from such services. The cost charged for such incidental benefits that are received is not a cost that can be charged as expense.

Example 21:

In a group that has a centralized information technology function, company LAC installs a new computerized system to handle orders in company WSR (an affiliate). Company WSR sells its products to third parties and also to company FEL (an affiliated company). The efficiency of company WSR's new system enables company FEL to reduce its overhead costs by reducing the staffing in the purchasing department.

Company FEL receives an incidental benefit from the service performed by company LAC for company WSR. Even if company LAC is not deemed to be providing service to company FEL, in an arm's length situation company FEL would not want to contribute to the charges for implementing the new system in company WSR, because the activities performed by company LAC aimed at meeting the needs of company WSR.

(4) Passive association

Passive association is a service that is paid to a related company simply because the taxpayer is a member of the company group.

Example 22:

There is no service fee that must be paid by a taxpayer simply because the taxpayer receives a higher credit rating when it is a part of the company group than when the taxpayer is not a part of the company group.





(5) On-call services

On-call services are services provided by one member of a business group (usually the parent company) that are always available at any time when needed by the taxpayer, or if provided by an independent party, there would be a special charge for such service to ensure its availability.

An on-call service may not be charged if:

- the potential for use of the service is very low,
- the benefit obtained from the service is insignificant (negligible), or
- the on-call service could be obtained immediately at any time and are available from another, independent party without first having to enter into an on-call service agreement.

In analyzing the potential use and benefits of on-call services that are provided, the Revenue Officers may consider the use of said services in the year concerned and previous years.

2) Perform calculation of the arm's length payment for the intra-group services.

The steps that need to be taken to calculate the arm's length nature of payments for services are as follows:

a) Review basis for charging fees for intra-group services.

The charging of fees for intra-group services should be based on the costs actually expended in providing the services. For example, a charge for management services should be based on the amount of cost actually spent, not based on the taxpayer's turnover. In order to know the basis for payment of intra-group service fees, the Revenue Officers have to:

- Look at the agreement documents for the intra-group services, and/or

➤ Conduct interviews with key personnel.

- b) Examine the components in the cost base actually expended by the service provider and their appropriateness to the service provided and the economic benefits for the taxpayer.

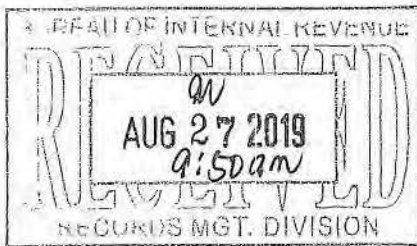
Example 23:

ASG Co. charges accounting services to PT TMD with the details of the cost base as follows: salary of accounting expert sent to Indonesia, bonus for director of ASG Co., round-trip Indonesia-X air ticket, and cost of holiday in Bali. In this case, ASG Co. cannot include the bonus for director of ASG Co. and the cost of holiday in Bali as components in the cost base of the accounting services charged to PT TMD.

- c) Examine the method for charging for the services used.

Methods for charging for services consist of the direct charges method and the indirect charges method.

(1) Direct Charges Method



- (a) The direct charges method is used in the situation where the service, the recipient of the service, the fee that is charged, and the basis for the charge can all be clearly identified. The charge can be allocated directly to the recipient.
- (b) The direct charges method should be applied by a service provider company when similar services are provided not only to related parties but also to unrelated parties.

(2) Indirect Charges Method

The indirect charges method is used when the direct charges method cannot be applied or when the charge relating to the services provided is not easy to identify and attribute to the related company.

Example 24:

Provision of information technology services such as an information management system that involves development, application and maintenance of electronic data for several members of a company group.

The indirect charges method is based on allocation of charges and the allocation that refers to the basis of the allocation (key

allocation) in accordance with the nature and purpose of the services provided. For example, provision of payroll services may be associated more with the number of personnel than with turnover, while the allocation for use of network infrastructure may be allocated in accordance with the number of computers.

d) Examine the basis for allocation of charges for services.

Application of the arm's length principle to intra-group service transactions requires that the amount of expense allocated to the group members is commensurate with the benefit expected from the services. The Revenue Officers are expected to document the analysis performed to select the basis of the allocation (key allocation). The basis of the allocation of charges for services should be adjusted to the nature and purpose of the services provided.

Allocation based on sales is acceptable if the taxpayer can explain the correlation between sales and the cost that is expended.

e) Examine whether there are comparables for the intra-group services and their mark-up and apply the transfer pricing method that is most appropriate to the conditions and facts.

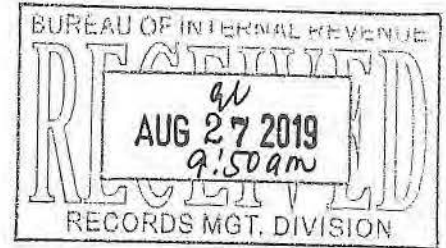
The methods that may be used in evaluating the arm's length nature of services fees include:

- (1) Comparable Uncontrolled Price Method;
- (2) Cost Plus Method; and
- (3) Transactional Net Margin Method.



CHAPTER VI

Intangible Asset Transactions



Intangible assets, for the purpose of transfer pricing analysis, are assets that are neither physical assets nor financial assets. Intangible assets are divided into two (2) major categories, comprising Manufacturing Intangibles and Marketing Intangibles.

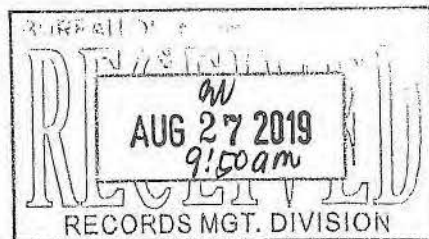
Steps of testing in connection with Intangible Asset Transactions:

- 1) Identify the existence of every intangible asset that makes a contribution to the success of the product in the market. This identification can be done through FAR analysis. In the FAR analysis, the Revenue Officers are expected to have a good understanding of the taxpayer's business.
- 2) Identify the value of intangible assets and determine which parties contributed to the formation of the intangible assets. This needs to be done so that it will be known whether the taxpayer in the Philippines contributed to the formation and is therefore entitled to enjoy the proceeds from the exploitation of the intangible assets.
- 3) Study whether there has been a transfer of intangible assets in the transaction. Analysis of the time of occurrence of transfer of intangible assets in independent transactions can serve as a guide.
- 4) Determine the arm's length compensation for each intangible asset that is transferred.

This is done by referring to the market where the intangible assets are used and comparing it with comparable transactions.

Testing of the arm's length nature for utilization or transfer of intangible assets must consider the perspectives of the party that delivers (transferor) and the party that receives (transferee) the intangible assets. The transferor must ensure that it will obtain greater benefit from the transfer/ utilization of the intangible assets than the costs that have been expended. On the transferee's side, the Revenue Officers will look at whether it will receive a greater benefit it uses/obtains the intangible assets than the costs that must be expended.

In testing the arm's length nature of intangible asset transactions, it is necessary to understand their type and characteristics. This understanding will make it easier to determine the factors that will affect the value of the license for the intangible assets and also to determine the comparable transactions. The factors that are generally used as the basis of consideration in determining the value of licenses for intangible assets include:



a) Protection and time frame

Certain kinds of intangible assets, such as patents, are protected by law for a certain period of time. This provided protection from competitors who would otherwise duplicate them. The longer the period of protection of the intangible assets, the greater the benefit that is expected to be received.

b) Exclusiveness

This relates to whether the utilization of the intangible assets is protected by an exclusive right or not. A party that utilizes intangible assets with exclusive rights should be willing to pay a higher royalty fee than a party that utilizes intangible assets without exclusive rights.

c) Geographical Coverage

The greater the geographical coverage provided, the greater the benefit is obtained.

d) Useful life of intangible assets

Certain intangible assets have a limited useful life. The useful life is influenced not only by legal protection as mentioned above but also by the level of technological inventions in a particular industry. Heavy competition in certain industries causes the useful life of intangible assets that are invented to be shorter.

e) Right to develop, revise, and make improvements

Protection of an intangible asset will be obsolete when new technology is invented. To be able to compete, the party that receives the benefit of the intangible assets may be given the right to take part in developing, revising and making improvements. If this right is granted, this needs to be considered in determining the value of the license of the intangible assets.

f) Existence of other intangible assets or services inherent in the delivery of utilization of the intangible assets. The utilization of certain intangible assets is often accompanied by continuing provision of services by the licensor. This needs to be considered in determining the amount of the royalty that is paid and in selecting comparables.

g) Existence of right to sublicense to third parties.

h) Other factors that could economically influence the value of the license for intangible assets.

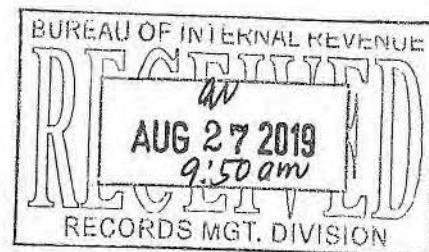
In the case that the taxpayer is the party makes use of (the Licensee) or the purchaser of the intangible assets, attention needs to be given to the following:

- a) The payment that is made will obtain a rate of return commensurate with the royalty that is paid. This is shown through financial analysis of the transaction.
 - b) The payment that is made will provide an economic benefit for the use of the intangible assets from the affiliated party.
- 5) The methods that can be used in evaluating the arm's length nature of transfer of intangible assets include:
- a) Comparable Uncontrolled Price Method;
 - b) Resale Price Method;
 - c) Cost Plus Method;
 - d) Transactional Net Margin Method;
 - e) Profit Split Method; and
 - f) Other methods;
 - (1) Methods based on cost approach
 - (2) Methods based on market approach
 - (3) Methods based on revenue approach



CHAPTER VII

Cost Contribution Arrangement



1. Concept of Cost Contribution Arrangement (CCA)

CCA is a framework in the form of contractual agreement among companies to share the costs and risks of developing, producing, or obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights. Each participant's proportionate share of the overall expected contributions to the arrangement will be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement. The participant would be entitled to exploit its interest in the CCA separately as an effective owner, not as a licensee. Where a taxpayer enters into a CCA separately with its associated party/ies, the arrangement should reflect that of an arm's length arrangement.

2. Types of CCA

There are two major types of CCA:

1. Arrangement for joint development of intangible property

In this arrangement each participant contributes different assets, resources and expertise, and receives a share of rights in the developed property based on the contribution.

2. CCA could exist for any joint funding or sharing of costs and risks, for developing or acquiring property or for developing or acquiring property or for obtaining services such as pooling resources for the development of advertising campaigns common to the participants' market. However, if a service arrangement does not result in any property being produced, developed or acquired, the principles for dealing with intragroup service will apply to that arrangement whether it is described as CCA or not.

Example 25:

Three members of a multinational group, marketing a product in the same regional market where consumers have similar preferences, want to enter a CCA to develop a joint advertising campaign. A fourth member of the group helps develop the advertising campaign but it does not have any beneficial interest in the services subject to the CCA activity and would not, in any case, have a reasonable expectation of being able to exploit any interest. The three participants in the CCA would, therefore, compensate the fourth member by way of an arm's length payment for the advertising services provided to the CCA.

3. Applying the ALP

To demonstrate whether a CCA accords with arm's length arrangement in comparable circumstances, the following matters should be addressed:

- a) CCA should be entered into with prudent and practical business judgment with a reasonable expectation of its benefits. An independent party would not enter a CCA where the value of the contribution exceeds the expected benefits. Estimation of the expected benefit to be derived from the arrangement can be computed in the following manner:
 - i) Based on the anticipated additional income that will be generated or the expected cost savings; or
 - ii) The use of an appropriate allocation key, perhaps based on sales, units used, produced or sold, gross or operating profits, number of employees, capital invested or alternative keys.
- b) Terms of the arrangement should be agreed upon up-front and in accordance with economic substance, judged by reference to circumstances known or reasonably foreseeable at the time of entry into the arrangement.

Consideration for the entry, withdrawal and termination of a CCA should be dealt with at arm's length, as follows:

- a) Where a participant's contribution is not consistent with its expected share of benefits from the CCA, a balancing payment may be required between the participants to adjust their respective contributions;
- b) Where a participant transfers its pre-existing rights of a prior CCA to a new participant, the exiting participant must be compensated based upon an arm's length value for the transferred interest (buy-in payment). The amount of the buy-in payment shall be determined based on the price an independent party would have paid for the rights obtained by the new participant, taking into account the proportionate share of the overall expected benefit to be received from the CCA; and
- c) Where a participant dispose off part or all of its interest, he should be compensated with an arm's length payment (buy-out payment).



CHAPTER VIII

Interest Payment Transactions

Audits of intra-group loan transactions are conducted to test the arm's length nature of the taxpayer's debt to equity ratio and to test the reasonableness of the interest rate and/or other expenses related to the intra-group loan transaction that are charged to the Taxpayer.

The steps that need to be taken in testing interest payment transactions include the following:

1) Perform analysis of the need for the debt.

Testing of fairness of debt and the amount of the debt to affiliated parties can be done by looking at the following factors:

a) Nature and purpose of the debt

The decision to make a loan must consider the economic conditions and purposes of incurring the debt with an affiliated party. The economic purpose of the loan is known by calculating a working capital analysis of the taxpayer.

b) Market conditions at the time the loan is extended

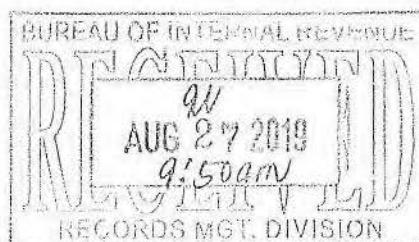
The decision to make a loan usually considers market interest rate conditions. When the interest rate is high, the taxpayer should consider more carefully the economic costs and benefits of the debt that is incurred.

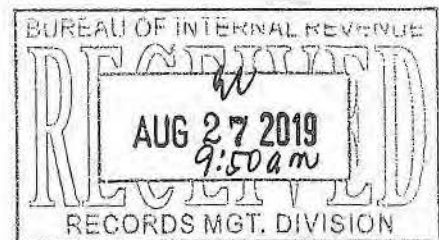
c) Amount of loan principal and period of the loan

The decision to make a loan should consider the amount of funds that is needed by the borrower for the intended economic purposes. In addition, the period for repayment should consider the taxpayer's ability to repay the loan.

d) Security offered by borrower and guarantees in the loan

The decision to make a loan and the amount of funds that are lent should consider the security of the funds that are provided. The guarantee in a loan may take the form of the taxpayer's assets or a personal guarantee from another party.





e) Amount of debt already held by borrower

The decision to make a loan should consider the amount of loans already held by the taxpayer. This relates to the taxpayer's ability to settle all its liabilities that arise, including payment of loan principal and interest. The taxpayer's ability to pay the interest expense can be calculated using the usual Interest Coverage Ratio of similar companies.

Calculation of the Interest Coverage Ratio can be done as follows:

$$\text{Interest Coverage Ratio} = \frac{\text{Earnings before Interest and Taxes (EBIT)}}{\text{Interest Charge}}$$

2) Confirm that the loan actually occurred.

To confirm that the loan actually occurred, the Revenue Officers can perform research on the loan agreement documents and the flow of cash of granting the loan and/or of repayment of the principal and/or interest.

3) Test the arm's length nature of the debt to equity ratio.

The arm's length nature of the debt to equity ratio can be determined by comparing with the debt and equity of similar companies. If the ratio is unreasonable, adjustments can be made.

4) Test interest rate of loans with affiliated parties.

Testing of the interest rate of loans with affiliated parties is done by comparing the interest rate of the loan with the affiliated party to the interest rate commonly used by independent parties. The interest rates commonly used by independent parties are usually calculated from a particular interest rate (for example BSP, LIBOR, SIBOR, USOR, or JISOR) plus a certain amount based on the credit rating of the party receiving the loan or other aspects.

5.) Determination of arm's length price/profit

After reliable comparables have been obtained and the transfer pricing method has been determined, the next step is to compare the price or profit of the affiliated transactions with the price or profit of the comparables in line with the method that is being used.

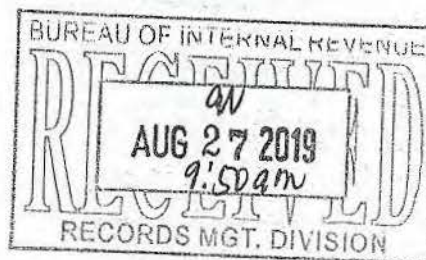
6.) Primary adjustments, secondary adjustments, and corresponding adjustments

The discrepancy between the price or profit of the affiliated transactions and the arm's length price or profit is a primary adjustment. If the primary adjustment is made on the level of profit, the Revenue Officers must attribute

the adjustment to profit to affiliated transactions with a high risk of tax avoidance.

The primary adjustments made by the Revenue Officers may lead to secondary adjustments. A secondary adjustment is a further adjustment that can occur because of the existence of a primary adjustment to the affiliated transactions. For example, the Revenue Officers make a positive adjustment to one of the Taxpayer's affiliated transactions. As a result of this correction, there is an overpayment to an affiliated party. For this overpayment, the Revenue Officers may make a secondary adjustment based on the applicable tax regulations.

Further, based on primary and secondary adjustments, corresponding adjustments may also be made in accordance with the applicable tax regulations.

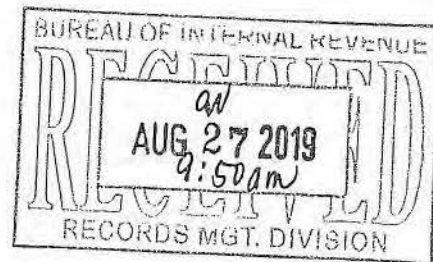


CHAPTER IX

Report Making

The Revenue Officers are required to make a report after the audit or investigation has been conducted.

In addition to the reporting requirements of the existing RAMO, Revenue Officers conducting the transfer pricing audit or investigation are required to comply with all the reporting requirements specifically provided in this Transfer Pricing Audit Guidelines.



ANNEX 1- Request Letter of Information or Proofs

DEPARTMENT OF FINANCE
Bureau of Internal Revenue

Number:
Type :
Encl :
Re : Information/Proofs Request

**First Notice to Give Information
on Related Transactions**

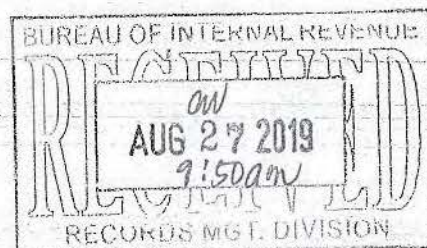
To (Name of Taxpayer)
(TIN)
(Address)

In connection with Letter of Authority (LOA) No. _____ dated _____, may we request for information /proofs as indicated in the list attached.

Please provide the information/proofs by no later than five (5) workdays after you receive this letter.

Thus we convey for your attention and thank you for your cooperation.

Received by : _____
Position : _____
Date : _____
Signature : _____



ANNEX 2 - Statement Letter

DEPARTMENT OF FINANCE
Bureau of Internal Revenue

STATEMENT LETTER

I, the undersigned

Name : _____
Occupation/Position : _____
Address : _____
Contact No. : _____
E-Mail Address : _____

In this case as

- ☐ Taxpayer
☐ Authorized Representative

of the taxpayer

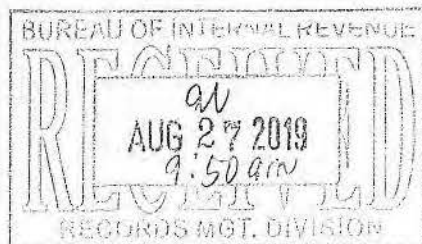
Company Name : _____
TIN : _____
Address : _____

herewith state that in the context of issuance of LOA No. _____ dated _____ covering Taxable Year _____, have given information in the form of:

- (1.) Related Party Transaction;
- (2.) Segmented Financial Statement
- (3.) Supply Chain Management Analysis;
- (4.) Function, Assets and Risks Analysis (FAR Analysis);
- (5.) Characteristics of Business; and
- (6.) Comparability Analysis as attached.

This Statement Letter has been duly made and signed with full awareness and without coercion from anyone whomsoever, and I am ready to be responsible for all legal consequences arising out of this statement.

Signature/Date
Taxpayer/Representative



ANNEX 3 - Related Party Transaction

DEPARTMENT OF FINANCE Bureau of Internal Revenue

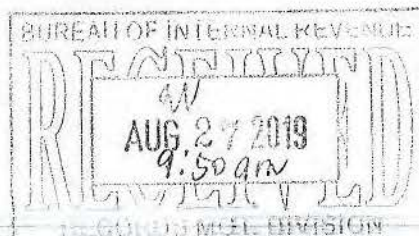
TAXPAYER : _____
TIN : _____
TAXABLE YEAR : _____
ADDRESS : _____

No.	Type of Transaction	Related Party	Value/Amount	Transfer Pricing Method	Remarks*
1.	Sale of :				
	a.) Goods				
	b.) Services				
	c.) Raw Materials				
	d.) Capital Goods (i.e., PPE)				
	Purchase of :				
	a.) Goods				
	b.) Services				
	c.) Raw Materials				
	d.) Capital Goods (i.e., PPE)				
2.	Delivery/Utilization of Intangible Property				
3.	Intercompany Loan/Advances				
4.	Payment for Services				
5.	Delivery/Acquisition of Financial Instrument such as Shares and Bonds				
6.	Shared Expenses**				
7.	Others				

* To be filled-out with information in connection with related party transaction of the taxpayer among other things, country of counterpart and reasons for selection of method

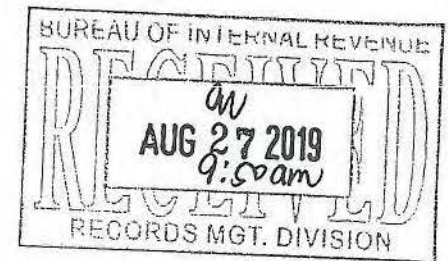
** Common expenses shared by related companies

This statement letter has been properly and duly made to be followed-up in accordance with the applicable laws.



Signature/Date
Taxpayer/Representative

ANNEX 4 - Segmented Financial Statement

DEPARTMENT OF FINANCE
Bureau of Internal Revenue

TAXPAYER : _____
 TIN : _____
 ADDRESS : _____

No. (1)	Item (2)	Transaction (3)	Amount (4)	Related Party (5)	Independent Party (6)	Amount (7)	Direct/Indirect Segmentation (8)	Remarks (9)
1.	Sale							
2.	Cost of Sales							
3.	Gross Profit = (1 - 2)							
4.	Gross Profit Rate= (3:1)							
5.	General and Administrative Costs							
6.	Net Operating Income							
7.	Operating Margin= (6:1)							
8.	Other Revenues							
9.	Other Costs							
10.	Profits before Tax							
11.	Profits before Tax: Sale (10:1)							
12.	Related party transaction							

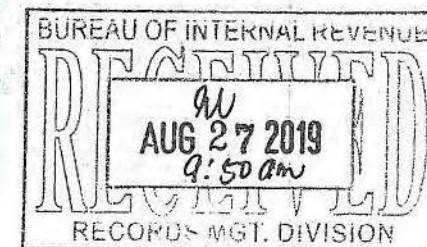
No. (1)	Item (2)	Transaction (3)	Amount (4)	Related Party (5)	Independent Party (6)	Amount (7)	Direct/Indirect Segmentation (8)	Remarks (9)
		(b.) Purchase from related party						
		(c.) Loan to /from related party						
		Interest:						
		Income						
		Expense						
		(d.) Services to related party						
		(e.) Royalty or License Fee to related party in connection with manufacturing						
		(f.) Royalty or License Fee to related party in connection with marketing						
		(g.) Other Costs to related party						
		TOTAL RELATED PARTY TRANSACTION						

This statement letter has been properly and duly made to be followed-up in accordance with the applicable laws.

Signature/Date
Taxpayer/Representative

Example:

Royalty cost of Company A in year 2016 is Php 1,000,000,000.00. With respect to the cost, Company A allocates to independent transaction entirely, meanwhile, related party transaction does not obtain allocation of royalty costs. Then, Column 4 is filled out with Php 1,000,000,000.00, whereas Column 5 is filled-out with Php 0.00.



ANNEX 5 - Supply Chain Management Analysis

DEPARTMENT OF FINANCE
Bureau of Internal Revenue

TAXPAYER : _____
TIN : _____
ADDRESS : _____

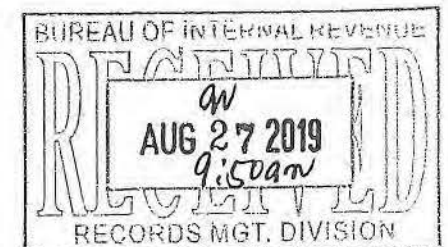
IMAGE

This statement letter has been properly and duly made to be followed-up in accordance with the applicable laws.

Signature/Date
Taxpayer/Representative

Note:

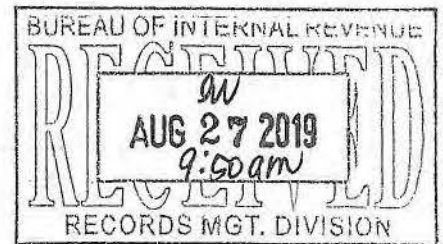
- (4) To be filled-out with other types of function in accordance with the need of information of Revenue Officers' team
- (5) To be filled-out with name of related company that performs function as described
- (6) To be filled-out with fiscal year of the moment the taxpayer is audited
- (7) To be filled-out with percentage of net operating income of company that performs function as described



ANNEX 6 - Function, Assets and Risks Analysis
(FAR Analysis)

DEPARTMENT OF FINANCE
Bureau of Internal Revenue

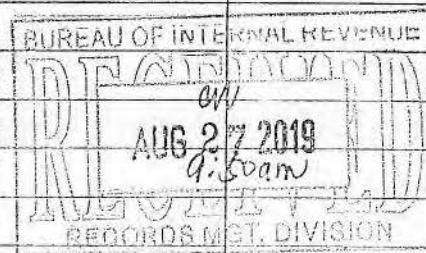
FUNCTION, ASSETS AND RISKS ANALYSIS



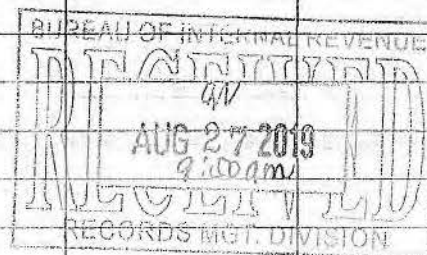
TAXPAYER : _____
N : _____
TAXABLE YEAR : _____
ADDRESS : _____

o.	Function/Assets/Risks	Taxpayer*	Name of Related Party	Name of Other Party	Remarks
1)	(2)	(3)	(4)	(5)	(6)
	Function				
	A. Purchase of Raw Materials				
	1. Selection of Supplier				
	2. Scheduling				
	3. Supervision on quality of material				
	4. Purchase of imported material				
	5. Purchase of local material				
	6. Distribution of imported material				
	7. Negotiation of prices of imported material				
	8. Negotiation of prices of local materials				
	9. Owner of raw materials				
	10.				
	B. Consignment of Raw Materials				
	1. Owner of raw materials				
	2. Person-in-charge of procurement of raw materials				
	3. Party who bears risk of increase in prices of raw materials				
	4. Contract of procurement of raw materials				
	5.				
	C. Research and Development				
	1. Fundamental research				
	2. Collection of information				
	3. Research and development of products				
	4. Determination of design of products				
	5. Determination of specification of products				
	6. Trial manufacturing				
	7. Development of products				
	8. Development of materials and technology				
	9.				
	D. Planning Production				
	1. Development of production channel				

lo.	Function/Assets/Risks	Taxpayer*	Name of Related Party	Name of Other Party	Remarks
	2. Improvement of efficiency of manufacturer				
	3. Bearer of risks of inefficiency of production line				
	4. Improvement of production line				
	E. Production Process /Processing				
	1. Producing products				
	2. Products scheduling				
	3. Products design				
	4. Packing and labeling				
	5. Improvement of products produced				
	6. Collection of information of products of competitor				
	7.				
	F. Ownership of Goods/Products				
	1. Who is the owner of finished products				
	2. Invoice is prepared in his name				
	3.				
	G. Assembling and Packing				
	1. Party who assembles products sold				
	2. Party who conducts packing (packaging)				
	3.				
	H. Warehousing in Logistics				
	1. Party who supervises stocks of finished products				
	2. Party who stores stocks of finished products				
	3.				
	I. Stipulation of Sale Price				
	1. Party who performs prices negotiation				
	2. Party who determines sale price				
	3.				
	J. Invoicing Collection				
	1. Party who issues sale invoice				
	2. Party who performs collection				
	3. Party who bears risks of uncollectible receivables				
	4.				
	K. Marketing, Advertising and Promotion				
	1. Market analysis				
	2. Market research				
	3. Market penetration (discount, volume, etc.)				
	4. Determination of market strategies				
	5. Person conducting exhibition				
	6. Serving customers				
	7. Advertising and promotion				
	8. Promoting trademark of products in the Philippines				



o.	Function/Assets/Risks	Taxpayer*	Name of Related Party	Name of Other Party	Remarks
9.					
	L. Quality Control (QC)				
	1. Testing quality of products				
	2. Troubleshooting after mass production				
	3. Determining standard operating procedure of quality control				
4.					
	M. Sale and Distribution				
	1. Prices negotiation				
	2. Receiving order from customers				
	3. Sale administration				
	4. Sales personnel				
	5. Signing of sale contract				
	6. Products distribution / delivery				
	7. Transportation costs guarantor				
8.					
	N. Others				
	1. Human research and development				
	2. General and administration				
	3. After sales services				
	4. Products guarantee and guaranty costs guarantor				
	5. Receiving claims against product				
	6. Transportation				
	7. Management				
8.	8. Finance				
	ASSETS				
	A. Intangible Assets				
	1. Owner of know-how in connection with production				
	2. Patent of product owner				
	3. License of know-how etc.				
	4. Trademark owner				
	5. License of trademark				
	6. Party giving contribution to development of intangible assets (for example: brand)				
	7. Ownership of intangible assets economically				
8.					
	B. Tangible Assets				
	1. Owner of machine equipment of factory				
	2. Owner of production facilities				
	3. Owner of land				
	4. Owner of building				
	5. Owner of production technology				



No.	Function/Assets/Risks	Taxpayer*	Name of Related Party	Name of Other Party	Remarks
	6. Owner of stocks				
	7.				
II.	RISKS				
	1. Party who bears R & D risks				
	2. Party who bears financial risks				
	3. Party who bears risks of imported raw materials				
	4. Party who bears risks of local raw materials				
	5. Party who bears risks inefficiency of production line				
	6. Party who bears risks of schedule of production				
	7. Party who bears risks of failure production				
	8. Party who bears market risks				
	9. Party who bears investment loss				
	10. Party who bears stocks risks				
	11. Party who bears risks of exchange rate /foreign currency				
	12. Party who bears risks of damage to products and guaranty				
	13. Party who bears risks of uncollectible receivables				
	14.				

Put a mark (✓ or X).



ANNEX 7 - Characteristics of Business

DEPARTMENT OF FINANCE
Bureau of Internal Revenue

CHARACTERISTICS OF BUSINESS

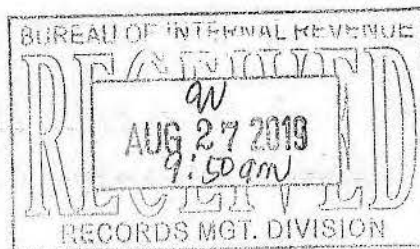
TAXPAYER : _____
TIN : _____
ADDRESS : _____

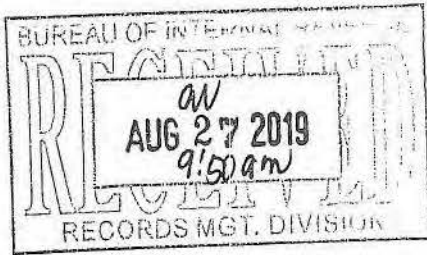
We state that characteristics of business based on function conducted, assets used, and risks borne of company that we carry on are as follows:

- 1.) Fully Fledged Manufacturing ☐
- 2.) Contract Manufacturing ☐
- 3.) Toll Manufacturing ☐
- 4.) Fully Fledged Distributor ☐
- 5.) Limited Risk Distributor ☐
- 6.) Commissionaire ☐
- 7.) Commission Agent ☐
- 8.) Service Provider ☐
- 9.) Others, ☐
please specify _____

This statement letter has been properly and duly made to be followed-up in accordance with the applicable laws.

Signature/Date
Taxpayer/Representative



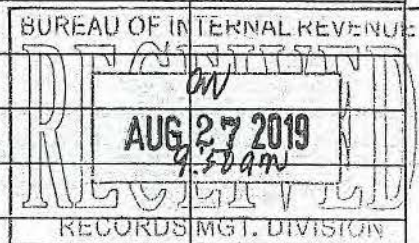


ANNEX 8 - Comparability Analysis

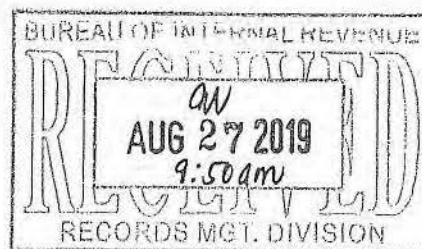
DEPARTMENT OF FINANCE
Bureau of Internal Revenue
COMPARABILITY ANALYSIS

No.	Comparability Factor	Category	Explanations	Related Transactions	Independent Transaction
1	Characteristic of Product and Service	Tangible Goods	a.) Physical characteristics of products		
			1.) Category of products		
			2.) Does product have special characteristics that are different from other products in the same category ?		
			b.) Quality of Goods		
			1.) Quality of products		
			2.) Durability of goods		
			3.) Target customers of products		
			c.) Availability of goods		
			1.) What is the volume of production?		
			2.) Does difference of production volume have significant influence to comparability? If yes, can the influence be eliminated?		
		Services	a.) Nature/type		
			1.) What is the type of services provided?		
			2.) Is there any agreement?		
			3.) Who bears costs?		
			b.) Coverage of Services		
			1.) Who is involved in agreement on services?		
			2.) How are costs allocated?		
			3.) How are the costs actually allocated?		
		Intangible Property	a.) Type of transaction (license of sale)		
			b.) Type (patent, trademark, etc.)		
			c.) Period and level of production		
			d.) Benefit expected		
			e.) Limitation or geographical area in the event that rights of utilization of intangible property are performed		
			f.) Restriction of export of products produced		
			g.) Exclusiveness of rights assigned		
			h.) Existence of rights of the party which obtains intangible property to take part in development of intangible property		
2	Function, Assets and Risks Analysis (FAR Analysis)	Function	a.) Purchase of Raw Materials		
			b.) Consignment of Raw Materials		

No.	Comparability Factor	Category	Explanations	Related Transactions	Independent Transaction
			c.) Research & Development		
			d.) Planning of Production		
			e.) Production Process/Processing		
			f.) Ownership of Goods/ Products		
			g.) Assembling and Packaging		
			h.) Warehousing and Logistics		
			i.) Stipulation of Sale Price		
			j.) Invoicing and collection		
			k.) Marketing, Advertising and Promotion		
			l.) Quality Control		
			m.) Sale and Distribution		
			n.) Others		
		Assets	a.) Intangible Asset		
			b.) Tangible Assets		
		Risks	a.) Party who bears R & D risks		
			b.) Party who bears financial risks		
			c.) Party who bears risks of imported raw materials		
			d.) Party who bears risks of local raw materials		
			e.) Party who bears risks of inefficiency of production line		
			f.) Party who bears risks of schedule of production		
			g.) Party who bears risks of failure of productions		
			h.) Party who bears market risks		
			i.) Party who bears investment loss		
			j.) Party who bears risks of stocks		
			k.) Party who bears risks of exchange rate/foreign currency		
			l.) Party who bears risks of damage to products and guaranty		
			m.) Party who bears risks of uncollectible receivables		
			n.) Others		
3	Contractual Term		a.) Is written contractual term consistent in its application?		
			b.) Is the written contractual term in accordance with general practice applicable?		
			c.) Is there common practice/habit applicable (not written)? If yes, what is the common practice?		
			d.) Does contractual term have substantial influence to comparability? If yes, can influence arising be eliminated?		
			e.) Others		
4	Economic Condition		a.) Stage/phase of company		



No.	Comparability Factor	Category	Explanations	Related Transactions	Independent Transaction
			b.) Stage/phase of products		
			c.) Geographical location of company		
			d.) Moment of transaction		
			e.) Market size		
			f.) Competitive situation/level of market competition		
			g.) Level of demand and supply in market whether on the whole or regionally		
			h.) Relative position of purchaser or vendor		
			i.) Availability of alternative products (substitute goods and services)		
			j.) Purchase power of consumers		
			k.) Nature and coverage of government regulation in the market		
			l.) Production costs including land costs, worker's wage, and capital, transportation costs, etc.		
			m.) Others		
5	Business Strategies		a.) Products innovation and development		
			b.) Level of diversification		
			c.) Bundle strategies		
			d.) Penetration to new market		
			e. Others		



ANNEX 9 - Supplemental Letter
Request for Information on
Affiliated Transactions

DEPARTMENT OF FINANCE
Bureau of Internal Revenue

Number:
Type : Urgent
Encl :

Second and Final Notice to Give Information
on Related Transactions

To _____

As the implementation of RR 2-2013 regarding Audit Procedure and in connection with books, records and documents already provided to the Tax Examiner based on LOA No. _____ dated _____ as well as information/proofs already requested in letter dated _____, you are requested on:

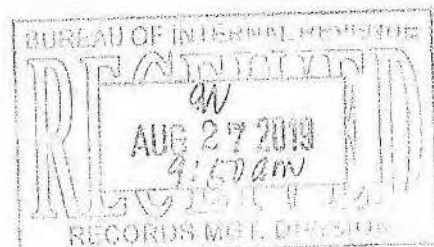
Day/Date : _____
Time : _____
Venue : _____

To give information/explanations and presentation to Tax Examiner Team in connection with:

- (1.) Characteristics of industry and market where company carries on business;
- (2.) Characteristics of related party transaction of company;
- (3.) Characteristics of company as part of group;
- (4.) Characteristics of taxpayer's business;
- (5.) Transfer pricing method used;
- (6.) Comparable used in applying arm's length principle to affiliated transaction;
- (7.) Determination of fair prices/profits of related party transaction; and
- (8.)

Please be informed accordingly.

Received by : _____
Position : _____
Date : _____
Signature : _____



**ANNEX 10 - Minutes of Provision
of Information on Taxpayer in
Respect of Affiliated Transactions**

DEPARTMENT OF FINANCE
Bureau of Internal Revenue

**MINUTES OF PROVISION OF INFORMATION ON TAXPAYER
IN RESPECT OF AFFILIATED TRANSACTIONS**

On this day _____ date _____ month _____ year _____ located in _____ we,
Revenue Officer team of the BIR:

Name of Employee	Designation	Position

Pursuant to LOA dated _____ have asked for information on related party
transaction/s in accordance with letter dated _____ to:

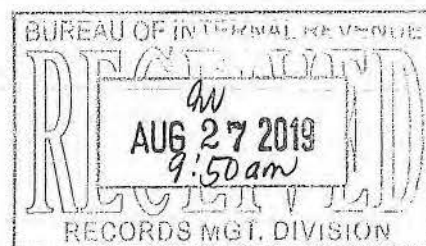
Name : _____
Occupation/Position : _____
Address : _____

In this case acting as

- ☐ Taxpayer
☐ Authorized Representative

of the taxpayer _____

Name of the Company : _____
TIN : _____
Address : _____



with the explanations as attached.

This Minutes of Provision of Information in Respect of Related Party Transaction/s has been duly made
and signed by:

Taxpayer

Revenue Officer