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Chapter -5

Comparability Analysis

SYNOPSIS

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INTRODUCTION

- Concept of *comparability analysis* is used in the selection of the most appropriate transfer pricing method as well as to arrive at an arm's length price or financial indicator (or range of prices or financial indicators) and thus plays a central role in the overall application of the arm's-length principle.

- This chapter focuses on searches for comparables, but it should be kept in mind that the lack of comparables for a taxpayer's controlled transaction is not determinative in that it does not mean that such transaction is or is not arm's length or that the arm's length principle is not applicable to that transaction.

RATIONALE OF COMPARABILITY ANALYSIS

- Finding the most reliable comparables.

- Comparability analysis is used to designate two distinct related analytical steps

a)an understanding of economically significant relevant characteristics of the Controlled transactions.

b) comparison between the conditions of the controlled transactions and conditions in transactions between independent enterprises taking place in similar circumstances

RATIONALE OF COMPARABILITY ANALYSIS

- Comparability factors, include:
  - characteristics of the property or service transferred
  - functions performed by the parties taking into account assets employed and risks assumed, in short referred to as the “functional analysis”
  - contractual terms
  - economic circumstances and
  - business strategies pursued.

COMPARABILITY ANALYSIS PROCESS

1.Understanding the economically significant characteristics of the industry, taxpayer's business and controlled transactions

- Gathering of basic information about the taxpayer
- Transaction analysis
- Evaluation of separate and/ or combined transactions

2. **Examination of comparability factors of the controlled transaction**

- Characteristics of the property or service transferred
- Functional analysis of the controlled transaction under examination
- Contractual terms of transaction
- Economic circumstances of transaction
- Business strategies of parties

COMPARABILITY ANALYSIS PROCESS (contd)...

3. Selecting the tested party

4. Identifying potentially comparable transactions - internal and external

5. Comparability adjustments where appropriate

6. Selection of most appropriate transfer pricing method

7. Determination of an arm's length price or profit (or range or prices or profits)

8. Documentation of comparability analysis and monitoring.

1) Understanding the economically significant characteristics of the industry, taxpayer's business and controlled transactions

➢ Gathering of Basic Information about the Taxpayer

- **Collection of background information about the taxpayer**
  - Understand its business operations and activities..
  - Taxpayer circumstances
  - Identification of associated enterprises involved in controlled transaction.

- **Sources of Information**
  - Annual report, product brochures, news articles,
  - Research reports prepared by independent agencies,
  - Management letters, internal reports

- **Purpose**
  - Industry to which enterprise belongs
  - Nature of its business activities (Manufacturer , wholesaler, distributor)
  - Market segment, Market share, Marker Penetration strategy

➢ Transaction analysis

- ALP must be established with regard to the transaction actually undertaken

- Recharacterisation of transactions by tax authorities (economic substance vs. legal form) leading to double taxation due to divergent views taken by countries on how the transactions are structured

➢ Evaluation of separate and combined transactions

- Transfer pricing analysis
  - On a transaction by transaction basis
  - Aggregation of closely linked / closely inter related or continuous transactions

- Where tax payer's transaction may be combined: example

(a) Long term service supply contracts

(b) Composite contracts and Packaged deal

- Non availability of third party information at transaction level
  - In practice
  - Frequently use of entity level information

Functional analysis

- Functional analysis is a process of finding and organizing facts about the transaction in terms of the functions, risks and assets in order to identify how these are divided between the parties involved in the transaction.

- <u>International controlled transactions of an enterprise.</u>

  F.A.R. analysis

  - Functions performed,
  - Assets employed and
  - Risks assumed

Functional analysis

- *Functions performed*

  - Research and development;
  - Product design and engineering;
  - Manufacturing, production and process engineering and design work;
  - Purchasing and materials management and other procurement activities;
  - Manufacturing, production or assembly work;
  - Transportation, warehousing and inventory;
  - Marketing, advertising, publicity and distribution;
  - Market intelligence on technological developments; and
  - Intra-group services,
    - Managerial,
    - Legal,
    - Accounting and finance,
    - Credit and collection,
    - Training and personnel management services.

Functional analysis

- *Assets employed*

  - Identify the type of significant assets (used by or transferred between the associated enterprises in the course of international controlled transaction)

    - Tangible assets

    - Intangible assets

Functional analysis

- ***Risks assumed***
  - Meaning: Identification of the significant risks that are assumed by each of the parties to the transaction.

  - Important aspects to risk :
    1) <u>How risk is created</u>
       - By ownership,
       - By exploitation or use of assets, or
       - By the performance of functions over time

    2) <u>Which entity bears the risk</u>
       - Identification of party having control over risk involves
         - Examination of factors
           - Core functions.
           - Key responsibilities
           - Key decisions
           - Level of individual responsibility for the key decisions

         Example 1 – Control over risk by parent company

         Example 2 – Control over risk by its subsidiaries

Functional analysis

- Type of risk in general (Depending on the nature of transaction) :

1. Financial risk
2. Product risk
3. Market risk
4. Collection risk
5. Entrepreneurial risk
6. General business risk
7. Country/regional risk

•To provide a clearer understanding of functional analysis and explain the chapter in a more practical manner, following are the hypothetical examples (Placed in Appendix I – Comparability) :

- Part 1: Example related to Functional Analysis (Manufacturing Entity)
- Part 2: Example related to Functional Analysis (Distributor)
- Part 3: Functional Analysis Checklists
- Part 4: Case Study based on a hypothetical Example

Contractual Terms of Transaction

- Explicit terms
  - Written contracts / agreements

- Implicit terms
  - Deduced from conduct of parties

Economic circumstances of the transaction

- Industry analysis
  - General factors for performing industry analysis
    - Global economic trends and developments relating to the industry to which the enterprise belongs
    - Economic trends in each taxpayer's country for the same industry
    - Market position of the enterprise and surrounding economic conditions.

Economic circumstances of the transaction

- Specific factors for performing industry analysis
  - Geographic location of the market
  - Market size
  - Level of the market
  - Competition in the market
  - Availability of substitutes
  - Government regulations of the market
  - Levels of supply and demand
  - Consumer purchasing power
  - Location-specific costs of production
  - Economic condition of the overall industry & the key value drivers in the industry
  - The existence of a cycle (economic, business, or product cycle); and
  - Other relevant factors.

Different geographical market / location

- Location savings
  - (a) Meaning
  - (b) How are location savings measured
- Location specific advantages
- Location rent
  - (a)Meaning
  - (b)What determines whether LSAs lead to location rents

Business strategies

- Importance in comparability analysis

  Takes into account many aspects of enterprise such as

  1. innovation and new product development;
  2. degree of diversification;
  3. risk aversion;
  4. assessment of political changes;
  5. impact of existing and planned labour laws;
  6. duration of arrangements and other factors bearing upon the daily conduct of business

Example of market share improvement strategy

1. Market penetration strategy
2. Market expansion strategy
3. Market maintenance strategy

Selection of the tested party

- The choice of the tested party
  - should be consistent with the functional analysis of the controlled transaction.
  - Attributes of controlled transaction(s) will influence the selection of the tested party (where needed).

- The tested party normally should be
  - less complex party to the controlled transaction
  - party in respect of which the most reliable data for comparability is available.
  - May be the local or the foreign party.

- Selection the foreign associated enterprise as the tested party (by taxpayer)
  - Necessary relevant information and sufficient data on comparables is furnished to the tax administration and vice versa in order for the latter to be able to verify the selection and application of the transfer pricing method.

Identification of potentially comparable transactions or companies

- Uncontrolled comparable transactions
  - **Internal comparables,** *i.e.* transactions between one of the parties to the controlled transaction (taxpayer or foreign associated enterprise) and an independent party; or
  - **Third-party or external comparables,** *i.e.* transactions between two independent parties, neither of which is a party to the controlled transaction.

- Steps for identification and selection of reliable external comparables :
  - Examination of the five comparability factors for the controlled transaction;
  - Development of comparable search or “screening” criteria;
  - Approach to identifying potential comparables;
  - Initial identification and screening of comparables; and
  - Secondary screening, verification and selection of comparable.

Development of comparable search or “screening” criteria

- Typical process of comparable search :
  - Database screening (primary screening),
  - Quantitative screening (secondary screening) and
  - Qualitative screening (tertiary screening).

- Explained by way of example to provide a clear understanding of screening criteria (Refer 5.3.4.43)
- The database screening applied with regard to :
  - Industry code
  - Geographic location
  - Level of market
  - Business mix
  - Scale of operations
  - Independence
  - Financial disclosure
  - Relevant period
  - Diagnostic Ratio

Identification of potentially comparable transactions or companies

- **<u>Information sources for third-party or external comparables.</u>**
  - Electronic data compilations
  - Other comparable data sources
    - Government sources
    - Trade institutions and organisations
      - Chambers of commerce
      - Trade and professional organisations
      - Embassies, Consulates, Trade missions
      - International organisations (such as UN agencies, OECD, World Bank, IMF).

Comparability Adjustments

- Important issues to be considered before an adjustment is made:
  - Quality of data being adjusted:
  - Purpose of adjustment performed
  - Not every transaction being compared is capable of being adjusted:
  - Reliability and accuracy of the adjustment:
  - Documentation

- Comparability adjustments :
  - Accounting Adjustment
  - Balance sheet Adjustment
  - Working Capital Adjustment
  - <u>Other Adjustments:</u>
    - Presence of significant intangibles
    - Risk Adjustment
    - Adjust for differences in transactional structure between the comparable and the tested party

Selection of Transfer Pricing Method

- Factors to be considered in selection
  1. Strengths and weaknesses of the method,
  2. Appropriateness of the method in the light of the nature of the controlled transaction (based upon a functional analysis),
  3. Availability of reliable information (especially on uncontrolled comparables)
  4. Degree of comparability between the controlled and the uncontrolled transactions (including reliability of comparability adjustments needed).

Issues regarding comparability analysis

- Some of the common concerns surrounding comparability analysis are :
  - **Timing issues**
    - o Timing of origin
    - o Timing of collection
    - o Valuation of highly uncertain at the outset and unpredictable events
    - o Data from years following the year of transaction
  - **Lack of reliable comparables**
    - o Due to lack of data
    - o Use of new technologies, products and services
    - o Consolidation and Vertical Integration
    - o Non - availability of data
  - "Cherry-picking" of comparables

Issues regarding comparability analysis

- Losses
  - o Start-up losses
  - o Deliberate business strategies
  - o Losses caused by recession
  - o Losses arising from increased competition
  - o Losses arising from product life cycle issues
  - o Losses arising from quality issues

- Evaluation of separate and combined transactions
- Intentional set-offs
- Use of customs valuations
- Use of secret comparables
- Overall process complexity

Conclusion

- Transfer pricing theory meets practice in comparability analysis – the translation of the arm's length principle into the selection of reliable comparables and of the appropriate transfer pricing method, eventually yielding the transfer price.

- Comparability analysis is an essential step in any transfer pricing analysis in order to gain a correct understanding of the economically significant characteristics of the controlled transaction and of the respective roles of the parties to the controlled transaction.

- The lack of comparables for a given controlled transaction does not mean that it is not arm's length or that the arm's length principle cannot be applied to it.

- The need for a reliable analysis must therefore be balanced with a pragmatic approach and one should not set unrealistic expectations for comparability analyses.

THANK YOU