

## ***Agenda Item 6***

### ***Working Draft***

## **Chapter 7**

### **Comparability Analysis**

*[This paper was prepared by Members of the UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues. It replaces the previous version of this paper.]*

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## 1. Rationale for comparability analysis

1.1. The arm's-length principle is generally applied in practice by establishing comparability between the conditions in a controlled transaction (i.e. transaction between the associated enterprises involved) and the conditions in uncontrolled transactions (i.e., transactions between independent parties). This concept of *comparability analysis* is used in the selection of the most appropriate transfer pricing method as well as in arriving at the correct arm's-length prices or profits 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.

*[To be decided: whether to move the following paragraph to Chapter 1: "A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent enterprises. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length.]"—Since it was decided to reduce the length of chapter 1, it would not be appropriate to overload that chapter and hence this may continue.*

1.2. 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. In some instances where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to determine whether the conditions of the transaction are ones that might be expected to have been agreed between independent parties in similar circumstances – lacking evidence of what independent parties have actually done in similar circumstances.

*[To be decided: whether to move to the end of the chapter 1: "In a number of instances, it will be possible to use "imperfect" comparables, e.g. foreign comparables or comparables from another industry sector, possibly adjusted to eliminate or reduce the differences between them and the controlled transaction."]—Since it was decided to reduce the length of chapter 1, it would not be appropriate to overload that chapter and hence this may continue.*

1.3. Controlled and uncontrolled transactions are regarded as comparable if their economically relevant attributes and the circumstances surrounding them are *sufficiently similar to provide a reliable measure of an arm's length result*. It is recognized that in reality two transactions are seldom completely alike and in this imperfect world apple to apple comparison is not possible. One must therefore use a practical approach in ascertaining the *degree of comparability* between controlled and uncontrolled transactions. To be

comparable does not mean that the two transactions are necessarily identical, but that either none of the differences between them could materially affect the arm's length price or profit or, where such material differences exist, that reasonably accurate adjustments (which are referred to as "comparability adjustments") can be made to eliminate their effect. The question what is a reasonably accurate comparability adjustment is further discussed later in this chapter. These comparability adjustments are to be made only if the effect of the material differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results.

1.4. The aforesaid degree of comparability is typically determined on the basis of a number of attributes of the transactions or parties that could affect prices or profits and the adjustment that can be made to account for differences. These attributes, which are usually referred to as the five comparability factors, include:

- (i) characteristic of the property or service transferred;
- (ii) functions performed by the parties taking into account assets employed and risk assumed, in short, termed as functional analysis (FAR);
- (iii) contractual terms
- (iv) economic circumstances;
- (v) business strategies pursued

1.5. Obviously, as the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate necessarily decreases. Also, in general, while adjustments can and must be made when evaluating these factors so as to increase comparability, the *number, magnitude and the reliability* of such adjustments affect the reliability of the overall comparability analysis.

1.6. It is important to note that the type and attributes of the comparables available in a given situation typically determine the most appropriate transfer pricing method. In general, closely comparable products(or services) are required if the comparable uncontrolled price ("CUP") method is used for arm's-length pricing; the resale price, cost-plus methods and transactional net margin method ("TNMM") generally require a lesser degree of products or services comparability and may be appropriate if functional comparables are available. This point is further discussed in the chapter on transfer pricing methods.

1.7. This chapter discusses a possible procedure to identify, screen, select and adjust comparables in a manner so as to enable the taxpayer or tax administration to make an informed choice of the most appropriate transfer pricing method and apply the same correctly to arrive at the appropriate arm's-length prices or profits (or range of prices or profits, as discussed later in this chapter).

## **2. Comparability Analysis process**

2.1 A typical approach that can be followed while performing a comparability analysis is outlined below. The steps below are by no means exhaustive but rather suggest an outline based on which comparability analysis could be carried out. The subsequent sections of this chapter deal with each of the below steps in more detail.

- A. Broad analysis of the controlled transaction(s) under examination and understanding the taxpayer business**
  - A.1 Gathering of basic information about the taxpayer**
  - A.2 Transaction analysis**
  - A.3 Evaluation of separate and combined transactions**
  - A.4 Selection of the tested party**
- B. Attributes or comparability factors**
  - B.1 Characteristics of products or services**
  - B.2 Functional analysis of the controlled transaction(s) under examination**
  - B.3 Contractual terms of transaction**
  - B.4 Economic circumstances of transaction**
  - B.5 Business strategies of parties**
- C. Identifying potential comparable transactions - internal and external**
- D. Comparability adjustments**
- E. Selection of most appropriate transfer pricing method**
- F. Determination of the arm's-length price or profit (or range or prices or profits)**
- G. Documentation of comparability analysis**

**A. Broad analysis of the controlled transaction(s) under examination and understanding the taxpayer business**

**A.1 Gathering of basic information about the taxpayer**

2.2 A pre-cursor to transfer pricing analysis is the collection of background information about the taxpayer and to understand its business operations and activities.

2.3 This requires an analysis of the taxpayer's circumstances including but not limited to the analysis of the industry, competition, economy and regulatory factors and other elements that affect the taxpayer and its environment.

2.4 Information about the taxpayer from its annual report, product brochures, news articles, research reports prepared by independent agencies, management letters, and internal reports could act as a good starting point to understand the taxpayer's circumstances. A study of these documents will provide an idea of the industry to which the enterprise belongs, the nature of its business activities (i.e. manufacturer, wholesaler,

distributor, etc.), its market segment, market share, market penetration strategies, type of products / services dealt, etc.

## **A.2 Transaction analysis**

2.5 The arm's length price must be established with regard to transactions actually undertaken; the tax authorities should not substitute other transactions in the place of those that have actually happened and should not disregard those transactions actually undertaken, unless in exceptional circumstances such as where the real economic substance of the transaction differs from its form. In general, restructuring of transactions should not be lightly undertaken as it would create significant uncertainty for taxpayers and tax administrations and may lead to double taxation due to the divergent views by countries on how the transactions are structured. Whether authorities are able to do so will in any case ultimately depend on the provisions of their ability to do so under applicable local law. These issues are relevant to the administration of transfer pricing, but also to developing the underlying legislation at the beginning of a country's transfer pricing "journey" to allow effective administration (and to assist compliance by taxpayers) during the course of that journey.

## **A.3 Evaluation of separate and combined transactions**

2.6 An important aspect of transfer pricing analysis is whether this analysis is required to be carried out with respect to a taxpayer's individual international controlled transactions or a group of international controlled transactions having close economic nexus.

2.7 Ideally transfer pricing analysis should be made on a transaction by transaction basis. However, there are cases where separate transactions are so closely linked that such an approach will not lead to an accurate result. Where transactions are so closely interrelated or continuous that application of the arm's length principle on a transaction-by-transaction basis becomes cumbersome for all involved, recourse is often had to evaluate transactions following an "aggregation" principle.

2.8 For example, with transactions dealing with intangible property such as the licensing of know-how to associated enterprises together with the supply of components to an associated manufacturer, it may prove difficult to separate out the transactions involved. Similarly long-term service supply contracts and pricing of closely linked products are difficult to separate out transaction-wise.

2.9 Another important aspect of combined transactions is the increasing presence of composite contracts and "package deals" in an MNE group; a composite contract and/or package deal may contain a number of elements including royalties, leases, sale and licenses all packaged into one deal. The tax authorities would generally want to consider the deal in its totality to understand how the various elements relate to each other, but the components of the composite package and/or package deal may or may not, depending on the facts and circumstances of the case, need to be evaluated separately to arrive at the appropriate transfer price. In certain cases, the tax authorities might find it appropriate for various reasons to allocate the price to the elements of the package or composite contract.

2.10 Aggregation issues also arise when looking at uncontrolled comparables. This is because, since third party information is not often available at the transaction level in the absence of an internal comparable, entity level information is frequently used in practice. It must be noted that any application of the arm's length principle, whether on a transaction by transaction basis or on an aggregation basis, needs to be evaluated on a case by case approach, applying the relevant methodologies to the facts as they exist in that particular case.

#### **A.4 Selection of the tested party**

2.11 When applying a cost plus, resale price or transactional net margin method, it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the controlled transaction. Attributes of controlled transactions will influence the selection of the tested party (where needed). The tested party normally should be the least complex party to the controlled transaction and should be the party in respect of which the most reliable data for comparability is easily and readily available. It may be a local or foreign party. If a taxpayer wishes to select the foreign related party as a tested party, it must insure that relevant information about it and sufficient data for comparability are available in the public domain or are furnished to the tax administration.

### **B. Attributes or comparability factors**

#### **B.1 Characteristics of the products or services**

2.12 Before entering into functional analysis, an important step is to analyze the relevant characteristics of the controlled transaction or taxpayer's business. Property, tangible or intangible, as well as services, may have different characteristics which may lead to a difference in their values in the open market. Therefore, these differences must be accounted for and considered in any comparability analysis of controlled and uncontrolled transactions. Characteristics that may be important to consider are:

- (i) In the case of tangible property, the physical features, quality, reliability and availability of volume and supply;
- (ii) In the case of services, the nature and extent of such services; and
- (iii) In the case of intangible property, the form of the transaction (e.g. licensing or sale) and the type and form of property, duration and degree of protection and anticipated benefits from use of property. For example, comparability analysis should take into account the difference between trademarks and trade names that aid in commercial exploitation (marketing intangibles) as opposed to patents & know-how (trade intangibles).

## **B.2 Functional analysis of the controlled transaction(s) under examination**

2.13 Functional analysis seeks to identify and compare the economically significant activities and the responsibilities undertaken by the independent and the associated enterprises. An economically significant activity is one which materially affects the price charged in a transaction and the profits earned from that transaction.

2.14 Functional analysis is the cornerstone of any transfer pricing exercise and its purpose is to describe and analyse the operations of an enterprise with its associated enterprises. Functional analysis typically involves identification of '**Functions** performed', '**Assets** employed' and '**Risks** assumed' (also therefore called "F.A.R analysis") with respect to international controlled transactions of an enterprise. This analysis of functions, assets and risks helps in establishing the comparability for the purposes of arm's length analysis.

2.15 The rationale behind FAR is that only if the uncontrolled transactions are functionally similar does it make sense to use them as benchmarks or comparables. For example comparing transactions in totally different *[verticals]* *[this may need further explanation]* in the software industry would not be appropriate during a comparability analysis.

2.16 The steps involved in performing functional analysis can be broadly classified into:

- i. Fact finding process;
- ii. Analysis of functions, assets and risks; and
- iii. Industry analysis.

### **i. Fact finding process**

2.17 Functional analysis is a process of finding and organizing facts about the transactions in terms of its functions, risks and assets in order to identify how these are divided between the parties involved in the transaction. The functions, risks and assets are analysed to determine the nature of functions performed, degree of risks undertaken and the kind of assets used by each party to the controlled transaction. This analysis helps to select the tested party, the most appropriate transfer pricing method, and the comparables, and ultimately to determine whether the profits (or losses) earned by the entities are appropriate to the functions performed, assets used and risks assumed.

2.18 The fact finding process will include identification of associated enterprises involved in the controlled transaction, identification of the taxpayer's international controlled transactions, and details about international controlled transactions (nature of products/ services transferred, value thereof, terms and conditions, etc.).

### **ii. Analysis of functions performed, assets employed and risks assumed**

2.19 In conducting functional analysis, an important rule is that the return earned by the entities involved in a transaction varies directly with the importance of the functions performed, the degree of risks undertaken, and the nature and value of assets deployed. It is therefore extremely important to map the functions performed, assets employed and

risks assumed by all the associated enterprises in relation to the controlled transaction under examination.

**a) *Functions performed***

2.20 Functions performed are the activities that are carried out by each of the parties to the transaction. In conducting functional analysis, important and significant functions are to be considered as such functions add more value to the transactions and therefore, are expected to fetch higher returns for the entity performing such functions. Thus, the focus should be not only on identifying the maximum number of functions but on identification of critical functions performed by the related parties.

2.21 Some of the important functions that are generally observed and examined in a transaction are:

- Research and development;
- Product design and engineering;
- Manufacturing, production and process engineering and designing work;
- Purchasing and materials management;
- Manufacturing, production or assembly work;
- Transportation, warehousing and inventory;
- Marketing, advertising, publicity and distribution;
- Managerial, legal, accounting and finance, credit and collection, training and personnel management services; and
- Intra-group services / Support services.

2.22 Functional analysis can be approached by listing all of the economically significant activities performed in relation to the controlled transaction under examination (such as a list indicated above), quantifying these activities, and then repeating the process for potentially comparable uncontrolled transactions. In some situations, a taxpayer should consider preparing this list for both parties to the transaction (e.g. for the producing and selling/distributing activities) to support the selection and application of the most appropriate transfer pricing method.

**b) *Assets employed***

2.23 One needs to identify the significant assets (tangible as well as intangible) used by or transferred between the associated enterprises in the course of international controlled transaction.

2.24 The analysis should involve identification of the type of capital assets used (e.g. plant and equipment, intangible assets, financial assets, etc.) and the nature of assets used, such as the age, market value, location, property right protections available, etc. . In some cases, depending on the facts and circumstances and on the type of transaction, it might be necessary to quantify the same.



2.25 In case of capital intensive industries, the employment of a capital asset such as property, plant and equipment, etc. is costly and has to be financed either internally or externally. However, there can also be cases where entities involved are doing pure assembly work for which the assets employed may not require huge capital investment.

2.26 It is also essential to know which entity developed the intangibles, which has the legal ownership of the intangibles, and which receives the economic benefit of the intangibles.

**c) Risks assumed**

2.27 Risk analysis involves identification of the significant risks that are assumed by each of the parties to the transaction.

2.28 In the open market, besides functions performed and assets used by the parties to the transaction, risks assumed are an important element in determining returns. The more the risks assumed by an enterprise, higher the returns that it expects, although the actual return may or may not increase depending on the degree to which the risks are actually realised. Conversely, in case where the risks undertaken by the enterprise in a transaction are minimal, the returns expected to be generated from such transactions should also be normally lower.

2.29 An illustrative list of the most common risks assumed by the parties to the transaction is provided below:

<b>Nature of risks</b>	<b>Particulars</b>
1. Entrepreneurial risk	a. Risk of loss associated with capital investment
2. Financial risk	a. Method of funding b. Fluctuation in interest rates c. Funding of losses d. Foreign exchange risk
3. Product risk	a. Design and development of product b. Upgradation / obsolescence of product c. After sales service d. Risks associated with R&D e. Product liability risk f. Intellectual property risk, if any g. Inventory risk
4. Market risk	a. Development of market including advertisement and product promotion, etc. b. Fluctuation in demand and prices c. Business cycle risk

5. Collection risk	a. Credit risk b. Bad debt risk
6. General business risk	a. Risk related to ownership of plant, property and equipment b. Environmental risk c. Infrastructural risk
7. Country / regional risks	a. Political risk b. Regulator risks, risks related to governmental policies

2.30 Risk analysis is important because it facilitates the making of comparability adjustments based on differences in risks that are undertaken in a controlled transaction as compared to uncontrolled transactions.

2.31 Furthermore it is not only necessary to identify the risks but also to identify who bears such risks. The allocation of risk is usually based on contractual terms between the parties; however these may not always reflect the reality of a transaction or a relationship, and an allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance.

2.32 The allocation of risk pursuant to a contract will generally be respected unless it is not consistent with the economic substance of the transaction. Parties transacting at arm's length would be expected to agree on the allocation of significant risks between them before the outcome of the risk-taking is known.

2.33 When analysing the economic substance of a transaction, it is necessary to examine whether the conduct of the associated enterprises over time has been consistent with the purported allocation of risk and whether changes in the pattern of behaviour have been matched by changes in the contractual arrangements.

2.34 In examining the economic substance of a risk allocation, it may be relevant, although not determinative, to examine which party(ies) has (have) relatively more control over the risk. Since in the arm's length dealings a party usually bears a greater proportion of the risk from business activities over which it exercises relatively more control, an economic substance analysis of a risk allocation should examine the extent to which a controlled taxpayer exercises managerial or operational control over the risk. The economic substance of a risk allocation may also depend on whether the risk-bearer has the financial capacity, at the time when risk is allocated to it, to take on the risk. This is not necessarily the financial capacity to bear the full consequences of the risk materialising (e.g. the full loss). In effect, the risk-bearer may protect itself from the consequences of the risk materialising (e.g. by hedging the risk or otherwise). Furthermore, a high level of capitalisation by itself does not mean that the highly capitalised party carries risk. Beyond the identification of these two relevant factors, it is not possible to provide prescriptive criteria that would provide certainty in all situations.

### **B.3 Contractual terms of transaction**

2.35 The conduct of the contracting parties is a result of the terms of the contract between them and the contractual relationship thus warrants careful analysis when arriving at the transfer price. Other than a written contract, the terms of the transactions may be figured out from correspondence and communication between the parties involved. In case the terms of the arrangement between the two parties are not explicitly defined, then the terms have to be deduced from their economic relationship and conduct.

2.36 One important point to note in this regard is that associated enterprises may not hold each other to the terms of the contract as they have common overarching interests, unlike independent enterprises, which are expected to hold each other to the terms of the contract. Thus, it is important to figure out whether the contractual terms between the associated enterprises are a “sham” (something that appears genuine, but when looked closer lacks reality, and is not valid under many legal systems) and/or have not been followed in reality.

2.37 Also, explicit contractual terms of a transaction involving members of a MNE may provide evidence as to the form in which the responsibilities, risks and benefits have been assigned among those members. For example, the contractual terms might include the form of consideration charged or paid, sales and purchase volumes, the warranties provided, the rights to revisions and modifications, delivery terms, credit and payment terms etc. This material may also indicate the substance of a transaction, but will usually not be determinative on that point.

2.38 It must be noted that contractual differences can influence prices as well as margins of transactions. The party concerned should document the significant contractual differences and evaluate them in the context of the transfer pricing methods discussed in detail in a later chapter of this Manual, in order to judge whether comparability factors are satisfied and whether any adjustments need to be made to account for such differences.

2.39 An example of how contract terms affect transfer pricing is as follows— Consider Company A in one country, an agricultural exporter, which regularly buys transportation services from Company B (its foreign subsidiary) to ship its product, cocoa beans, from Company A’s country to overseas markets. Company B occasionally provides transportation services to Company C, an unrelated domestic corporation in the same country as Company B. However, provision of such services to Company C accounts for only 10% of the gross revenues of Company B and the remaining 90% of Company B’s revenues are attributable to provision of transportation services for cocoa beans to Company A. In determining the degree of comparability between Company B’s uncontrolled transaction with Company C and its controlled transaction with Company A, the difference in volumes involved in the two transactions and the regularity with which these services are provided must be taken into account where such factors would have a material effect on the price charged.

## **B.4 Economic circumstances of the transaction**

2.40 Economic analysis deals with industry analysis and circumstances that may be relevant for determining market comparability. The relevant information on industry can be broadly classified as follows:

- Global economic trends and developments relating to the industry to which the enterprise belongs;
- Economic trends in the taxpayer's resident country for the same industry; and
- Market position of the enterprise and surrounding economic conditions.

2.41 Undertaking a more detailed classification of the above broad heads would yield the following specific factors which may need to be looked at in performing industry analysis where they are relevant and significant for the examined controlled transaction (this list is not exhaustive):

- (a) Geographic location of the market;
- (b) Market size;
- (c) Level of the market;
- (d) Competition in the market;
- (e) Availability of substitutes;
- (f) Government regulations of the market;
- (g) Levels of supply and demand;
- (h) Consumer purchasing power;
- (i) Location-specific costs of production; and
- (j) Economic condition of the overall industry & the key value drivers in the industry.

2.42 Market prices for the transfer of the same or similar property may vary across different markets owing to cost differentials prevalent in the respective markets, which can affect the cost of supply and/or the market price. Markets can be different for numerous reasons; it is not possible to itemise exhaustively all the market conditions which may influence transfer pricing analysis but some of the key market conditions which influence such an analysis are as follows:

2.43 **Geographical location** – In general, uncontrolled comparables ordinarily should be derived from the geographic market in which the controlled taxpayer operates, because there may be significant relevant differences in economic conditions between different markets. If information from the same market is not available, an uncontrolled comparable derived from a different geographical market may be considered if it can be determined that (i) the differences between the two markets do not materially affect the price or profit of the transaction or (ii) reasonably accurate adjustments can be made to account for such material differences between the two markets.

2.44 Another aspect of having different geographic markets is the concept of “location savings” which may come into play during transfer pricing analysis. Location savings are the cost savings that a MNE realises as a result of relocation of operations from a high cost jurisdiction to a low cost jurisdiction. Typically, cost savings include savings on costs of labour, raw materials and tax advantages offered by the new location. However, there might be disadvantages in relocating also; the “dis-savings” on account of relocation might be higher costs for transportation, quality control, etc. The net savings attributable to relocation from a high cost into a low cost jurisdiction (offset by any “dis-savings”) is referred to as the “location saving”. The important point, where there are such location savings, is not just the amount of the savings, but also the issues of to whom these savings belong (e.g. the captive service provider or the principal). In this respect, the allocation of location savings depends especially on the relative bargaining positions of the parties. Relative bargaining power of buyer, seller and end user is dependent on the rights of the parties, the beneficial ownership of intangible property and the relative competitive position.

2.45 The identification of location savings might seem simple in theory; however its actual computation may pose many difficulties. Moving to an offshore location might be accompanied by changes in technologies, productions volumes or production processes. In such a circumstance, the additional profit derived cannot be treated as only due to location savings as the profitability is due both to low costs and introduction of new technology. A simple comparison before and after in such a scenario would give a distorted picture of location savings.

**<Allocation of location savings will be the subject of further debate within the group members and will be added in the next amendment>**

2.46 If the tax authorities were to administer transfer pricing principles to “shift” profits without any consideration of market forces prevalent in the respective countries, then such reconfiguration of economic profile, and consequently the financial statements in the host country, would be against the principles of transfer pricing and may result in unrelieved double taxation if the tax authority in another country does not agree to similarly reduce the profits of an associated enterprise in its country.

2.47 **Government rules and regulations** – Generally, government interventions in the form of price controls, interest rate controls, exchange controls, subsidies for certain sectors, anti-dumping duties etc, should be treated as conditions of the market in the particular country and in the ordinary course they should be taken into account in arriving at an appropriate transfer price in that market. The question becomes whether, in light of these conditions, the transactions by associated enterprises are consistent with comparable uncontrolled transactions between independent enterprises.

2.48 An example of where government rules affect the market is that certain pharmaceutical formulations may be subject to price regulation in a particular country. Another example is Export Oriented Units (EOUs) which may be subject to beneficial provisions under the taxation laws of the country; ideally companies which enjoy similar

privileges should be used as the comparables, and if that is not possible, comparability adjustments may need to be made as part of the comparability analysis.

**2.49 Level of Market** – For example, the price at the wholesale and retail levels would generally differ.

**2.50 Other market conditions** - Some other market conditions which may influence the transfer price include costs of production (including costs of land, labour and capital), availability of substitutes (both goods and services), level of demand/supply, transport costs, size of the market, the extent of competition.

## **B.5 Business strategies of parties**

**2.51** Business strategies relating to new product launches, innovations, market penetration or expansion of market share may require selling products cheaper as part of such a strategy and thus earning lower profit in the anticipation of increased profits in the coming years, once the product has become more established in the market. Such strategies must be taken into account when determining the comparability of controlled and uncontrolled transactions.

**2.52** For example, “start-up” companies are prone to incurring losses during their early life and more so in the new jurisdiction where there is a competition from the existing players. Hence to establish themselves they may have to adopt the strategy of selling the products at a lower margin or to bear losses for a time. Therefore it would not generally be appropriate to include such start-ups when the tested party (i.e. the party in the controlled transaction to which the transfer pricing method is applied) is a company with a track record over many years.

**2.53** Another example where business strategy comes into play is a company which imports equipment from its overseas affiliate and resells it to domestic customers. This is typically done as part of an overall contract of supply and installation; the company would normally resell the equipment at cost but is compensated for the low price by way of increased earnings through after sales service and maintenance contracts.

**2.54** The evaluation of the claim that a business strategy was being followed which decreased profits in the short-term but provided for higher long-term profits is one that has to be considered by the tax authorities carefully after weighing several factors. One factor being - who bears the cost of the market penetration strategy? Another factor to consider is whether the nature of relationship reflects the taxpayer bearing the cost of the business strategy –for example, a sales agent with little responsibility or risk typically cannot be said to bear costs for a market penetration strategy. Another factor is whether the business strategy itself is prima facie plausible or needs further investigation; an endless “market penetration strategy” that has yielded no profits in many years might under examination have no such real basis in practice.

## **C. Identification of comparables**

2.55 Comparables are of two types:

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

### **(a) Internal comparables**

2.56 Even though internal comparables may possibly display a higher degree of comparability, there is need to subject internal comparables to as rigorous a scrutiny as external ones with regards to comparability factors and to make comparability adjustments when necessary. Use of internal comparables may have advantages but also requires caution as mentioned below; accordingly, it will require careful consideration of the facts and circumstance of a case.

2.57 Advantages:

- i. Internal comparables may have a more direct and closer relationship to the transaction under review than external ones due to one party to the transaction being the same and to the use of identical accounting standards.
- ii. Transaction specific financial and other information such as a FAR analysis are more likely to be available.
- iii. Comparability analysis involving internal comparables may be less expensive for the taxpayer as no public database search is required.

2.58 Cautions:

- i. Internal comparables need to be subject to as rigorous a scrutiny as external ones with regards to availability of transactional information (such as transactional comparable uncontrolled price, or reliable segmental information on profit levels, depending on the transfer pricing method used), comparability factors and comparability adjustments where necessary.
- ii. Potential internal comparables may not be necessarily the best evidence if there are differences e.g. in transaction volumes, contractual terms, geographical markets and business strategy which are material and cannot be eliminated through reliable comparability adjustments.

2.59 Internal comparables, where available and reliable, may allow the taxpayer to consider use of the Comparable Uncontrolled Price (CUP) method because it is the most direct method and relies on exact comparables. Internal comparables may also be used with the other recognised transfer pricing methods.

2.60 However, appropriate and reliable internal-comparables often do not exist to cover the broad scope of controlled transactions at issue. Thus, the taxpayer must examine external sources for potential comparable transactions among third parties.

**(b) Third-party comparables / External comparables**

2.61 The identification and selection of reliable external comparables can be executed in a three step process:

- b.1. Examination of the five comparability factors for the controlled transaction;**
- b.2. Comparable search criteria development;**
- b.3. Approach to identifying potential comparables**
- b.4. Initial identification and screening of comparables; and**
- b.5. Secondary screening verification and selection of comparables.**

Below is an illustration of how such a process can be performed, especially in cases where external comparables are extracted from a database.

**b.1. Examination of the five comparability factors for the controlled transaction**

2.62 This analysis examination is described in Sections B clause 2.12 to 2.54above. It will help both in developing search criteria and in establishing comparability benchmark.

**b.2. Comparables search criteria development**

2.63 Comparable search criteria are developed based upon the results of the above mentioned examination of the five comparability factors in relation to the controlled transaction. These criteria must be defined so as to identify those external uncontrolled transactions that meet the requirements of comparability vis-à-vis the controlled transaction and tested party.

2.64 The search criteria should be set so as to select the most reliable comparables. At the same time, the initial search criteria should not be overly restrictive, in order not to set unrealistic expectations in terms of comparability. Once potential comparables have been selected, reasonably accurate comparability adjustments can be performed where necessary to enhance the reliability of the comparisons. Availability of reliable comparables will influence the choice of the most appropriate transfer pricing method.



### **b.3. Approach to identifying potential comparables**

2.65 In identifying potentially comparable uncontrolled transactions or enterprises, two approaches are possible: the “additive” and the “deductive”.

2.66 In the additive approach, a list of third parties is prepared which are believed to be carrying on the potentially comparable transactions. The taxpayer shall then collect as much information as possible on transactions conducted by these third parties to confirm whether they are in effect acceptable comparables, based on the five comparability factors for the controlled transaction. While adopting the additive approach, one may take special care that a potentially third party company which may be well-known in the relevant industrial sector should be comparable too. Also, one needs to avoid potential third party companies which have transfer pricing issues in themselves.

2.67 The deductive approach usually commences with a search on a database for comparable companies or transactions. These can be commercial databases developed by editors who compile accounts filed by companies with the relevant governmental authorities or proprietary databases developed by some advisory firms.

2.68 It needs emphasis here that exclusive use of either of the approaches may not yield valuable results. Depending on case by case basis, the above approaches can be used in combination.

2.69 Combining the “additive” and “deductive” approaches may lead to being selective or “cherry picking” and therefore one is cautioned when adopting this approach. If companies are identified from the additive approach which have not been picked up as a result of the deductive approach, this may suggest that the search strategy applied under the deductive approach is not sufficiently robust and should be reassessed. Therefore, the additive approach could be useful for assessing whether the deductive search strategy is reliable, comprehensive and appropriate given the economic characteristics being considered.

2.70 It is very important that the taxpayer justify and document the criteria used to include or exclude particular third party data in order to ensure a reasonable degree of objectivity and transparency, i.e. in particular the process should be reproducible by a tax administration that wishes to assess it. It is also very important that third party data be refined using qualitative criteria. It would be improper to use financial information relating to the transactions of a large sample of companies that have been selected solely because they are classified.

### **b.4. Initial identification and screening of comparables**

2.71 The following broadly defined criteria are illustrative of those typically employed in an initial search process to identify and screen potential external comparables. The selection criteria must be tailored to the characteristics of the controlled transaction under examination. The criteria below must be matched with the specific transfer pricing method chosen:

**i. Establish comparability benchmarks**

*a. Geographic, product/service market*

2.72 Where available, comparables from the same market(s) as the market of the tested party are generally preferred. However, in many countries the availability of independent comparables, or of public information on independent comparables, is limited. Use of foreign comparables may be considered, where they satisfy the comparability factors as discussed in this chapter.

*b. Mix of functions, level of market*

2.73 Comparables will generally be selected among companies performing the same or similar mix of functions as the tested party and operating at the same level of market.

*c. Business mix*

2.74 In practice, available third party data are often aggregated data, at a company-wide or segment level, depending on the applicable accounting standards. Whether such non-transactional third party data can provide reliable comparables for the taxpayer's controlled transactions depends in particular on whether the third party performs a range of materially different transactions. Where segmented data are available, they can provide better comparables than company-wide, non-segmented data, because of a more transactional focus, although it is recognised that segmented data can raise issues in relation to the allocation of expenses to various segments. Similarly, company-wide third party data may provide better comparables than third party segmented data in certain circumstances, such as where the activities reflected in the comparables correspond to the set of controlled transactions of the taxpayer.

*d. Scale of operations*

2.75 Comparables must be selected such that their financial performance reasonably reflects the scale of economies of the controlled party depending upon the nature of business service. Size criteria in terms of Sales, Assets or Number of Employees are often used, as the size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore comparability.

*e. Independence*

2.76 Only uncontrolled transactions can be used as comparables. However, companies having small related party transactions which do not affect gross or net margin may be used as uncontrolled comparables.

*f. Financial disclosures*

2.77 Public or private companies reporting a reasonably standard and detailed accounting of the income statement and balance sheet data provide an objective baseline for subsequent analysis. Restricting the comparable search to public companies also has clear advantages. Many regulatory agencies around the world require filing of audited financial statements that conform to generally accepted accounting principles. Also public company audited financial statements provide considerably more detail in their financial statements and in the accompanying notes and management review of operations. Further, audited financial statements are available in a relatively consistent form over time, including retrospective restatement of data wherever necessary, which allows for the use of multi-year statistical analysis that can be applied in prospective pricing decisions.

*g. Relevant period*

2.78 Comparables must be selected such that the relevant operations and available financial data reflect appropriately the business cycle and general economics of the year or period at issue. The contemporaneous transactions are most likely to reflect similar economic conditions and ensure higher degree of comparability. However there can be exceptions to the above general rule, where a multiple year comparison is made taking into account the data for years before and/or after the year under review.

2.79 Circumstances that may warrant consideration of data from multiple years include the extent to which complete and accurate data is available for the tax year under review, the effect of business cycles in the taxpayers industry, or the effects of life cycles for a particular product or intangible. However, the existence of any such cycle needs to be aptly demonstrated by the taxpayer.

**<Multiple year and timing issue is the subject of further debate within the group members and will be added in the next amendment>**

2.80 Having developed a set of comparability criteria that are tailored to the specifics of the controlled transaction at issue, the next step is to conduct an initial identification and screening of potential independent comparables. The objective in this initial screening, where performed using a commercial database, is to identify substantially all companies that have a reasonable probability of demonstrating the threshold comparability requirements and of providing verifiable, objective documentary evidences of market pricing. In other words, the desired initial result is to obtain the largest possible pool of potential independent comparables for subsequent screening, verification, and analysis. Where comparables are selected from other information sources than databases, this part of the process may be different. For other data sources, refer paragraphs 2.90 and 2.91.

2.81 However the following analytical needs and constraints should be kept in mind:

- The sampling process should avoid any systematic biases.

- Statistical techniques (such as the use of averages, median, interquartiles etc.) should only be used where the resultant data series have a sufficient number of companies and observations per company to support them.
- The screening process must be executed and documented in a manner consistent with the general requirement for due diligence.
- It should be recognised, that some of the initial comparables will be eliminated in subsequent stages of screening and analysis.

#### **b.5. Secondary screening, verification, and selection**

2.82 Under this step, the search process focuses on a rigorous review of each company in the potential independent comparable pool against the full range of specific screening criteria. In this step, the objectives are verification and final screening and selection. This process is based on trial and error and requires multiple data sources, crosschecks, and selected follow-up and confirmation of factual data.

2.83 The taxpayer must use a variety of company specific information sources including annual reports, regulatory and other government filings, product literature, and securities analyst reports, as well as various trade and industry association materials. Once intermediate screening has been accomplished, a complete set of company financial statement data should be generated and reviewed for adequacy, period coverage, and general consistency. Sometimes a taxpayer may even obtain details through telephone or personal interviews with company management and can also use the knowledge of internal operating personnel to identify comparables. For example, sales and marketing personnel can be asked to assist in identifying independent third-party resellers whose financial statements may be used as a basis for establishing comparable profit margins.

#### ***Information sources for third-party or external comparables.***

2.84 There are various sources of data and information which are available to assist a taxpayer in identifying potential comparables. Possible sources range from electronic databases, regulatory and other government filings, various analytical reports issued by trade and industry associations. The search objective is to identify the most reliable comparables for the controlled transaction under examination according to the specific set of comparability criteria.

2.85 The data sources provide the taxpayer with a vast array of information. Some provide simple leads or contacts, or a starting point to learn more about a particular industry so that appropriate comparable are ultimately selected. Others provide business profiles and detailed financial information about comparables. Each source can be important to establish and document the quantitative basis for an arm's length transfer pricing policy.

#### ***(a) Electronic data compilations***

2.86 A general source of information are databases which have been developed by various organizations which compile accounts filed by the companies with the relevant

administrative bodies and present them in an electronic format suitable for searches and statistical analysis. Some of these databases compile domestic as well as foreign companies financial data. These products typically provide detailed financial information as well as some textual information such as short business descriptions.

2.87 The advantage of electronic databases in the comparable search process is that they can provide the ability to sort quickly and retrieve selectively only the desired results that meet certain screening criteria.

2.88 Criteria commonly used for initial screening may include inter alia

- i. have geographic restrictions with respect to a country or region;
- ii. require a specific industry classification;
- iii. refer to keywords;
- iv. eliminate all those enterprises which may have transfer pricing issues themselves and fail an independence screening;
- v. include or exclude specific functions such as research and development, production, distribution, and holding of shares;
- vi. exclude companies which were only recently set up;
- vii. consider diagnostic ratios such as turnover per employee, ratio of Net Value of Intangibles / Total Net Assets Value or ratio of Research and Development / Sales etc; and
- viii. focus on a sales volume or a fixed assets or number of employees.

The above listed screening criteria depend on the facts and circumstances of each particular case and the above list is neither limitative nor prescriptive.

2.89 It is important to note that electronic databases rely on publicly available information which may not be available in all countries, since not all countries have the same amount of publicly available information about their companies. Further, due to the different disclosure and filing requirements depending on the legal form of the enterprise, the information may not be in a similar type of format making it difficult for comparison. Most of these databases are used to compare the results of the companies rather than of transactions because third-party transactional information is not readily available.

2.90 Commercial databases can be a practical and sometimes cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case. However a number of limitations to commercial databases are frequently identified apart from an often high cost, and commercial databases are not available in all countries. The use of commercial database is not compulsory and it may be possible to identify reliable comparables from other sources of information.

*(b) Other comparable data sources*

2.91 There are other data sources available to provide more detailed business mix, product lines, geographic market, functional mix, and ownership information on the first-

round selection of potential comparable as well as to identify additional companies that should be considered. These include the following:

- Government sources - many governments and regulatory agencies maintain databases on several industries. Such sources can be located on the agency's Internet websites.
- Trade institutions and organisations - often institutions or organisations will maintain databases, research reports, and/or files with data on potential comparables. Generally these institutions or organisations would be:
  - Chambers of commerce
  - Trade and professional organisations
  - Embassies, Consulates, Trade missions
  - International organisations (such as United Nations agencies, Organisation for Economic Co-operation and Development, World Bank, International Monetary Fund).

2.92 Information available with tax administrators based on examination of other taxpayers or from other sources of information not available to the taxpayer (also called “secret comparables”) should not be used unless the tax administration is able to (within limits of confidentiality) disclose the data to the taxpayer so as to defend itself against an adjustment. Use of secret comparables should be avoided as the same is not available in public domain and hence the taxpayer probably never had the opportunity to apply the same while pricing their controlled transactions.

#### **D. Adjustment to comparables**

2.93 Given that seldom are two transactions very similar and that data points may be sparse, comparability adjustments often become necessary. Some adjustments are often capable of being measured in a reasonably reliable manner (for instance, working capital adjustments, bad debt risk, etc.). Some other adjustments, by their very nature, tend to be subjective and fraught with interpretation issues. Furthermore, the nature and magnitude of such adjustments may be disputed by the taxpayer or tax authorities.

2.94 For example, tax authorities may not agree with the adjustments made to domestic sales in order to use it as a comparable for exports due to non-availability of other comparables. Another example of a contentious adjustment may be the magnitude of risk adjustment to be made for start-up companies as opposed to well-established companies.

2.95 Certain adjustments may be required so that the financial results of the comparables are stated on the same basis as those of the tested party. Potentially, five types of adjustments can be made to the financial statements of the comparable:

**a. Provide accounting consistency with the tested party**

2.96 Accounting differences between the tested party and comparables can lead to measurement errors, if adjustments are not made. Adjustments may be necessary to ensure accounting consistency with the tested parties' measurement of trading capital and operating profit.

**b. Restate, as necessary, for divestiture or acquisitions**

2.97 Restatement adjustments can be made where needed to ensure consistency with the tested party's measurement of trading assets and liabilities and operating profit. Divestitures or acquisitions are accounted for by restating year beginning and year ending balance sheets either to include or to exclude acquired or divested businesses.

**c. Segment and eliminate significant non comparability in product markets or functional operations**

2.98 If a potential comparable with significant non-comparable operations discloses sufficient and reliable financial information in the form of segmented sales, operating profit, and identifiable assets for comparable and non-comparable segments, a segmentation procedure can be used to eliminate these returns from the return on comparable functions.

**d. Adjust for functional differences**

2.99 There can be significant differences in the mix of functions performed by the comparables vis-à-vis the tested party, or in the assets used, risks assumed or capital employed. When such differences exist and are not adjusted, they limit the usefulness of the comparables in establishing an appropriate arm's-length profit range.

2.100 To eliminate the effect of such differences, the financial results of the comparables may need to be adjusted, e.g. by eliminating the margins associated with the functions performed by the comparables but not by the tested party, or by including arm's length returns for functions performed by the tested party but not performed by the comparables.

2.101 These adjustments to address differences between and among the comparables and the tested party in the functions performed can be classified into the following three distinct categories :

*i. Working capital adjustment*

2.102 It is very common for the tested party and each of the comparables to differ substantially in the amount of working capital. Such differences are generally caused by differences in the financing terms of purchase and sale that the company receives from its suppliers and extends to its customers, and by differences in the levels of inventories held by the company. Such differences may generate substantial differences in the capital structure and operating profits of the companies. In order to reduce the effect of

differences in terms of purchase and sale and levels of inventories on the profitability measures, adjustments can be made to normalize the receivables, payables, and inventory levels of the comparables and the tested party. The receivables, payables, and inventory balances are adjusted such that the days that each are held are equivalent to a normalized number of days. Operating profit is adjusted, in parallel, to reflect the return required in order to hold the increased level of payables, receivables, or inventories. This, however, should be done only if such adjustment can be reasonably made and it improves comparability.

2.103 Adjustments for inventory, accounts receivable, and accounts payable follow the same basic mechanics. First, a value is established for the difference between the function performed by the comparable and the tested party. The value can be established by calculating the difference between the ratio of the balance sheet item in question to net sales for the comparable and the same ratio for the tested party. The denominator of these fractions will be an arm's length amount for the tested party example, denominator of PLI can be used. An alternative approach would be to calculate these ratios with respect to operating expenses like where Gross Profit / Operating Expense are the PLI used. The resulting difference in ratios is then multiplied by an interest rate and by the net sales of the comparables to generate an amount to adjust the income statement of the comparable. Then, the PLI of that comparable is recomputed.

2.104 The following Illustration is hypothetical, but demonstrates how a working capital adjustment can be calculated.

Particulars	Tested Party	Comparable Party
Sales (A)	100	100
EBIT (B)	5	7
Operating Profit Margin (PLI) (A/B in %) (C)	5%	7%
<b>Net Working Capital ('NWC')</b>		
Accounts Receivable (D)	100	110
Inventory (E)	20	40
Accounts Payable (F)	50	40
Net Working Capital (G) (D+E-F)	70	110
Difference between Tested and Comparable Party (H)		-40%
Interest Rate on NWC (I)		5%
Adjustment (J) (I*H)		-2%
Working Capital Adjustment – Re-computing PLI for Comparable (C-J)		5%



**<Accounting adjustment is due for further debate within the group members and will be added in the next amendment>**

*ii. Differences in functional mix*

**<decided not to delete>**

2.105 Where there are significant differences in the mix of functions performed by the comparables vis-à-vis the tested party, the feasibility of reasonably accurate adjustments to eliminate the effects of such differences on the comparison should be considered. For example, a controlled distribution company may differ from a set of independent distribution companies in that it performs import and regulatory functions not performed by the independent distributors, performs only first-tier distribution functions, and performs limited manufacturing and assembly functions. To adjust for such differences, the financial results of the comparables may need to be adjusted in a reasonably accurate manner to eliminate the margins associated with the functions performed by the comparables but not by the tested party or to include arm's length returns for functions performed by the tested party but not performed by the comparables. Such adjustments may be performed by reference to an arm's length return earned by internal or external comparables, subject to them being reasonably accurate; in practice it will often be determined by reference to the returns earned by companies that perform solely those functions.

2.106 For example, consider adjustments performed to iron out the material differences in the mix of functions performed by a controlled storage device distributor and a set of independent storage device distribution comparables. Assume that the independent device distributors also perform manufacturing/ assembly operations and downstream distribution functions that are not performed by the controlled storage device distributor. In this case, the financial results of the comparables may need to be adjusted to eliminate the margin portions associated with manufacturing/ assembly operations and with downstream distribution functions based upon the profitability earned in uncontrolled comparable storage manufacturing and downstream distribution transactions. On the other hand, assume now that the controlled storage device distributor performs some import functions which are not performed by the independent distributors. The margins of those comparables that did not perform import functions may need to be increased to reflect an arm's length return associated with these functions.

*iii. Presence of significant intangibles*

2.107 Where the comparables' profits are partially attributable to significant, intangibles which are not found in comparables, such as unique product design or engineering, that are not present in the tested party, it may not be possible to eliminate the effects of such intangibles on operating profits by performing reliable comparability adjustments. In such cases, the potential comparables may need to be rejected.

**e. Adjust for differences and transactional structure between the comparables and the tested party**

2.108 It is to be recognised that the class of problems that arises due to significant differences in the transactional structure between related party sales in a controlled company and similar transactions involving independent companies.

2.109 These problems typically arise in controlled situations when the parties allocate the risks and functions of the enterprise among themselves in a way that they would not if they were independent. The differences in the bargaining power and degree of common interest of the related parties and the independent companies may lead to very different transaction terms, such as extremely long-lived contracts, or instances where unique intangibles that would not ordinarily be transferred between unrelated companies are undertaken between the controlled parties.

2.110 When material differences in the structure of the transaction exist between a set of potential comparables and the tested party due to the very fact that the transactions to be priced are not arm's-length, the search for comparable that have the same transactional structure is fruitless. In the circumstances, the taxpayer will need to adjust the financial results of comparables to reflect these differences.

2.111 For example, the margins of independent distributors may not be comparable to those in long run, related party situations unless an adjustment is made to account for the short duration of the former. In such a case, the total amount of marketing investment required in launching a product and the annual profit required to recoup this investment plus a reasonable return over different investment periods is determined. The annual profits have to be adjusted by an amount equalling the difference between the annual profit required to recover the investment over the comparables' investment horizon and over the tested party's overall investment period.

2.112 It has to be stressed that comparability adjustments should be considered if and only if they are expected to increase the reliability of the results. Relevant considerations in this regard include the materiality of the differences for which an adjustment is being considered, the quality of the data subject to the adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.

2.113 The comparability adjustments are only appropriate for differences that will have a material effect on the comparison. A comparison may be appropriate despite an unadjusted difference, provided that the difference does not have a material effect on the reliability of the comparison.

**f. Comparability Adjustments - Judgment**

2.114 No specific rules or guidelines can be documented for universal applicability to every transaction and which would indicate for which comparability differences adjustments must be made. In each case, the critical factors that have material impact on the price of

the product (if CUP method is used) or on gross profit (if the RPM or Cost Plus Method or TNMM is used) should be identified. Ultimately, this decision depends entirely on the facts and circumstances surrounding the transactions and on the availability of information needed for the analysis.

2.115 Available information often is not complete enough to compare each possible comparability factor. The analysis almost always takes place with imperfect information. That realisation can be helpful in deciding whether a particular difference is material enough to make adjustments, or whether the difference should affect the selection of the best method.

#### **E. Selection of the most appropriate transfer pricing method**

2.116 The most appropriate transfer pricing method will be selected taking into account the comparability analysis and the availability of reliable comparables.

2.117 Once the taxpayer has identified the pricing methods that are potentially applicable to the controlled transaction, application of the most appropriate method rule involves a careful balance in which the following factors are taken into account to assess the relative accuracy of the identified methods:

- i. The extent to which the uncontrolled transactions or entities are similar to the controlled transactions or entities, given the type of comparability that is required under each pricing method;
- ii. The reliability and amount of financial and other information that is known about the comparables;
- iii. The reliability, number, and magnitude of required accounting, functional, risk, and other comparability adjustments that would have to be made under each method;
- iv. The reliability and appropriateness of the measures of economic performance (for the controlled and uncontrolled transactions) that can be used under each method; and
- v. The number and quality of methodological presumptions that must be made in applying each method. In most cases, it is possible to identify the most appropriate method based on a related group profiles and an overview of intermediate markets.

2.118 Once the transfer pricing method is selected, the next logical step is to apply the selected method to arrive at the correct arm's-length price or profit (or range of prices or profits), which is dealt with more fully in other chapters of this Manual.

2.119 Another important and necessary requirement while doing comparability analysis is to maintain complete documentation of the analysis, evaluation and selection (and rejection) of comparables along with a substantiation of the adjustments made, if any. Complying with documentation requirements may be a significant but unavoidable burden for the taxpayer. Chapter [9] deals in detail with all these documentation requirements.

### **3 Issues regarding comparability analysis**

3.1 Comparability analysis should be as reliable as possible and on many occasions does not tend to yield perfect matches in terms of comparables of transactions carried out by the associated enterprises. The nature, type, quality etc and number of comparables along with the adjustments made during comparability analysis may be subject matter of debate, interpretation and contention between the taxpayer & tax authorities.

3.2 Some of the common concerns surrounding comparability analysis are:

#### **a) Dearth of comparables**

3.3 One of the most frequent problems taxpayers face with comparability analysis is the dearth of comparables with respect to the transactions they carry out. There may be a number of reasons for this paucity of comparables:

3.4 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. In some instances where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to determine whether the conditions of the transaction are ones that might be expected to have been agreed between independent parties in similar circumstances – lacking evidence of what independent parties have actually done in similar circumstances.

##### *a.1. Due to emerging economies*

3.5 In many developing countries, functionally comparable transactions may simply not be available. It may be due to the fact that a particular sector was only recently opened up or liberalized by the government (or) due to the advent of a new sector or industry in the region. The available comparable transactions in such cases are at best inexact and have to be adjusted for to arrive at a reasonable degree of comparability. It may be possible under certain circumstances to use foreign comparables, possibly adjusted, to deal with these situations.

##### *a.2. Use of new technologies, products & services*

3.6 Similarly, when products, property or services are offered by first-movers in specific segments there may be a dearth of comparables. These transactions typically involve new technology, cutting-edge research, bundled intangibles etc. which may not have satisfactory comparables. An example is intellectual property content relating to high-tech computer software. Such situations are usually dealt with either by using a one-sided method (cost plus, resale price or TNMM) for which the tested party is the one that does not contribute such intangibles; or, in those cases where unique intangibles are contributed by both parties to the transaction, by using a profit split method.

##### *a.3. Consolidation & Vertical Integration*

3.7 Due to consolidation and vertical integration it may be extremely difficult to find good internal or external comparables. An example is the pharmaceutical industry where there exists a high level of vertical integration and consolidation in order to drive up efficiencies. In such scenarios the controlled transactions are part of a larger global supply-chain and it can become difficult to arrive at comparable transactions. It may be possible under certain circumstances to use comparables from other industries, possibly adjusted, in order to address this issue.

*a.4. Non-availability of data*

3.8 In a number of countries comparable data might not be available in the public domain (or) there may not be enough resources or processes in place to collate and make available this data for consumption. It may be possible under certain circumstances to use foreign comparables, possibly adjusted, to deal with these situations.

**b) “Cherry-picking” of comparables**

3.9 In practice, it is frequently not possible to obtain perfectly comparable information, and it is therefore necessary to use broad search criteria when identifying third party comparable. However, it must be ensured that potentially relevant external comparables are not excluded because of “cherry picking” of favourable third party information by either the taxpayers or the tax authorities. For example, loss-making companies may be rejected as comparables by the tax authorities as they tend to skew the data; while this could be true in certain circumstances, on the other hand the reasons for the loss maybe genuine like a recession year or due to the enterprise being in start-up phase etc. To come to a correct conclusion, an unbiased analysis of the facts and circumstances surrounding the transactions has to be carried out. See also discussion of losses below.

3.10 A well documented search procedure and comparability criteria makes the comparability standard transparent, in that the comparability standard that was applied is clearly stated and its scope can be evaluated. This will ensure that results are less susceptible to “cherry picking” since the reasons for rejection of each potential comparable are provided.

**c) Losses**

3.11 In an MNE group, one of the enterprises might be suffering a loss, even a recurring one, but the overall group may be extremely profitable. The fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may warrant scrutiny by the tax authorities concerned. Such a situation perhaps indicates that the loss-making enterprise is not getting adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities. However the tax authorities must appreciate the fact that these losses, if short-term, may be the result of a deliberate business strategy for market penetration. However the question as to who will bear the cost

of market penetration should be carefully examined. A large loss for a low risk business is questionable because it may belong to an MNE.

3.12 Where one or more of the potential comparables are loss-making, further examination would be needed to understand the reasons for such losses and confirm whether the loss-making transaction or company is a reliable comparable. The losses might be due to exceptional conditions met by an otherwise comparable third party. Simple or low risk functions in particular are not expected to generate losses for a long period of time. This does not mean however that loss-making transactions can never be comparable. It is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result.

<<Discussion on losses is in due for further debate within the group members and will be added in the next amendment>  
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#### **d) Intentional set-offs**

3.13 A deliberate or intentional set-off occurs when an associated enterprise has provided a benefit to another associated enterprise within the MNE group and is compensated in return by that other enterprise with some other benefits. These enterprises may claim that the benefit that each has received should be set-off against the benefit each provided and only the net gain or loss if any on the transactions needs to be considered for tax assessment.

3.14 Set-offs can be quite complex; they might involve a series of transactions and not just a simple one transaction, two party set-off. Ideally the parties disclose all set-offs accurately and have enough documentation to substantiate their set-off claims so that after taking account of set-offs, the conditions governing the transactions are consistent with the arm's length principle.

3.15 The tax authorities may evaluate the transactions separately to determine which of the transactions satisfy the arm's length principle. However, the tax authorities may also choose to evaluate the set-off transactions together, in which case comparables have to be carefully selected; set-offs in international transactions and in domestic transactions may not be easily comparable, including due to possible asymmetries in the tax treatment of the set-offs under the taxation systems of different countries.

#### **e) Use of custom valuations**

3.16 The General Agreement on Trades and Tariff (GATT, Article VII), now part of the World Trade Organization (WTO) set of agreements, has laid down the general principles for an international system of custom valuation. Customs valuation is the procedure applied to determine the customs value of imported goods. Member countries of the WTO typically

harmonise their internal legislation dealing with the customs valuation with the WTO Agreement on Customs Valuation.<sup>1</sup>

3.17 In appropriate circumstances, the documented custom valuation may appropriately be used for justifying the transfer prices of imported goods in international transactions between associated enterprises. The arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises and the value of similar goods imported by independent enterprises, although valuation methods for customs purposes may not be aligned with the recognised transfer pricing methods. However when there is no customs duty imposed and goods are valued only for statistical purposes, and for items which have no rate of duty, this approach would not be useful.

3.18 Even when utilising the customs valuation for imports in a transfer pricing context, certain additional upward or downward adjustments may be required to derive the arm's length price for the purpose of taxation.

3.19 Internationally, there is a great deal of focus on the interplay of transfer pricing methods on the one hand and custom valuation methods on the other hand. Debates have centred on the feasibility and desirability of the convergence of the systems surrounding the two sets of value determination. Those who favour the convergence, point to the higher compliance costs to business and higher enforcement costs to government arising out of two sets of rules existing in the same government. The opponents of this view point to the different principles underlying the determination of value for levy of customs duty and for levy of tax on profits. The issue is considered in more detail in [a later chapter].

#### **f) Use of secret comparables**

3.20 There is often concern expressed by enterprises over aspects of the data collection by tax authorities and its confidentiality. The fact is that tax authorities are privy to, as they need to be, very sensitive and highly confidential information about taxpayers, such as relating to margins, profitability and business contracts. Confidence in the tax system means that this information needs to be treated very sensitively, especially as it may reveal sensitive business information about that taxpayer's profitability, business strategies and so forth.

3.21 A secret comparable generally means the use of information or data about a taxpayer by the tax authorities to form the basis of transfer pricing scrutiny of another taxpayer, which is often not given access to that information – it may reveal confidential information about a competitor's operations, for example.

3.22 Secret comparables should not be used unless the tax administration is able to (within limits of confidentiality) disclose the data to the taxpayer so as to defend against an adjustment. The taxpayers contend that use of such secret information is against the basic principles of equity, as the taxpayer is required to benchmark its controlled transactions

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<sup>1</sup> See [http://www.wto.org/english/tratop\\_e/cusval\\_e/cusval\\_e.htm](http://www.wto.org/english/tratop_e/cusval_e/cusval_e.htm)

with comparables not available to it, without the opportunity to question comparability or argue that adjustments are needed. If adjustments are made on this basis, the taxpayer faces the consequences of additions to its income, typically coupled with interest, penalties etc.

#### **g) Overall process complexity**

3.23 Comparability analysis on paper looks simple but in practice it can be a laborious, time-consuming and, more often than not, an expensive exercise. Seeking information, analyzing all the data from various sources, documenting the analysis and substantiating adjustments, all cost precious time and money. It is therefore important to put the need for comparability analyses into perspective keeping in mind the extent of the burden and costs that should be borne by a taxpayer to identify possible comparables and obtain detailed information thereon. It is recognised that the cost of information can be a real concern, especially for small to medium sized operations, but also for those MNEs that deal with a very large number of controlled transactions in many countries.

3.24 When undertaking a comparability analysis, there is no requirement for an exhaustive search of all possible relevant sources of information. . In the real life no doubt it is a difficult task, however exercise judgment to determine whether particular comparables are reliable

### **4 Conclusion on comparability analysis**

4.1 Transfer pricing theory meets practice in comparability analysis – the translation of the arms'-length principle into the selection of the appropriate transfer pricing method and eventually its application to yield the transfer price is facilitated by comparability analysis.

4.2 It is clear that comparability analysis should be as reliable as possible so as to arrive at the correct arm's length price or profit (or range of prices or profits). In doing this comparability analysis it may be necessary for the taxpayer or the tax authorities to undertake a detailed functional analysis taking into consideration a wide variety of data sources, of factors and, if necessary, a series of comparability adjustments while arriving at a suitable set of benchmarks (or comparables). The choices made in the course of this analysis have to be substantiated and the overall process has to be thoroughly documented.

4.3 Comparability analysis, wherever it tends to be an open-ended problem, can benefit from as much effort and careful analysis of the facts & circumstances of the transactions involved as is possible in such cases.

4.4 It suffices to say that comparability analysis forms one integral part of any transfer pricing study and without it no transfer pricing study would be complete. It is however essential to put the need for comparability analyses into perspective given the extent of the burden and costs that can arise to a taxpayer or tax administration to identify possible comparables and obtain detailed information about them. Taxpayers and tax administrations should exercise judgment to determine whether particular comparables are



reliable. Furthermore, as noted in introduction, 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. This is especially important given the growing importance of integrated business models and of transactions involving unique intangibles for which comparables may not be available. The need for a reliable analysis must therefore be balanced with a pragmatic approach and one should not set unrealistic expectations for comparability analyses.