

Chapter 5

Comparability Analysis

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5.1 Rationale for Comparability Analysis

5.1.1. The phrase “comparability analysis” is used to designate two distinct though related analytical steps:

- An understanding of the economically significant characteristics of the controlled transaction, *i.e.* the transaction between associated enterprises, and of the respective roles of the parties to the controlled transaction. This is generally performed through an examination of five “comparability factors”, as discussed below.
- A comparison between the conditions of the controlled transaction and conditions in uncontrolled transactions (*i.e.* transactions between independent enterprises) taking place in comparable circumstances. The latter are often referred to as “comparable uncontrolled transactions” or “comparables”.

5.1.2. This concept of comparability analysis is used in the selection of the most appropriate transfer pricing method to the circumstances of the case, as well as in applying the selected transfer pricing method to arrive at an arm’s length price or financial indicator (or range of prices or financial indicators). It thus plays a central role in the overall application of the arm’s length principle.

5.1.3. A practical difficulty in applying the arm’s length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. 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, or is not, arm’s length.

5.1.4. It should be kept in mind that the lack of a comparable for a taxpayer’s controlled transaction does not mean that such transaction is or is not at arm’s length or that the arm’s length principle is not applicable to that transaction. In a number of instances it will be possible to use “imperfect” comparables, e.g. comparables from different countries having comparable economic conditions or comparables from another industry sector, possibly adjusted to eliminate or reduce the differences between such transaction and the controlled transaction. In other instances where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to use a transfer pricing method that does not depend on comparables (see the discussion in Chapter 6). It may also be necessary to examine the economic substance of the controlled transaction to determine whether its conditions are such that might be expected to have been agreed between independent parties in similar circumstances – in the absence of evidence of what independent parties have actually done in similar circumstances.

5.1.5. A controlled and an uncontrolled transaction are regarded as comparable if the economically relevant characteristics of the transactions being compared 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 perfect comparables are often not available. 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 can be made to eliminate their effect. Thus, in determining a reasonable degree of comparability, adjustments may need to be made to account for certain material differences between the controlled and uncontrolled transactions. These adjustments (which are referred to as "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.

5.1.6. The aforesaid degree of comparability is typically determined on the basis of a number of attributes of the transactions or parties that could materially 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:

- 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.

5.1.7. 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 may affect the reliability of the overall comparability analysis.

5.1.8. 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, the cost-plus method and the transactional net margin method (TNMM), may be appropriate if the functional comparables are available, i.e. where the functions performed, assets employed and risks assumed by the parties to the controlled transaction are sufficiently comparable to the functions performed, assets employed and risks assumed by the parties to the uncontrolled transaction so that the comparison makes economic sense. An example would be two comparable distributors of consumer goods of the same industry segment, where the goods distributed may not be exactly the same, but the functional analyses of the two distributors would be comparable. This issue is further discussed in the chapter on transfer pricing methods.

5.1.9. Practical guidance is needed for cases without sufficient comparables. There seems to be two distinct problems relating to comparables for developing countries. The first relates to the inability to effectively access existing sources, such as existing non-local company databases. The second relates to the lack of reliable local country comparables. For each of these, there are problems associated with both administration (e.g., how the lack of data impedes the reliable and efficient determination of appropriate arm's length results) and problems associated with double tax/dispute avoidance (e.g., how the lack of appropriate data impedes a developing country's ability to reach agreement with other tax authorities, or prevent the developing country from being taken advantage of).

5.1.10. The 2010 version of the OECD Transfer Pricing Guidelines points out that non-domestic comparables should not be automatically rejected merely because they are not domestic. The guidelines further recommend that where independent transactions are scarce in certain markets and industries a pragmatic solution may need to be found on a case-by-case basis.¹ This means that when the data is insufficient, stakeholders can still use them as comparables, after in-depth adjustments are made, to assess the arm's length price. The validity of such procedures depends heavily on the accuracy of the comparability analysis as a whole.

5.1.11. This chapter discusses a possible procedure to identify, screen, select and adjust comparables in a manner that enables the taxpayer or tax administration to make an informed choice of the most appropriate transfer pricing method and apply that method correctly to arrive at the appropriate arm's length price or profit (or range of prices or profits).

5.2 Comparability Analysis Process

5.2.1. 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 a comparability analysis could be carried out. It may be noted that the process is not linear, for example a number of the steps may need to be carried out repeatedly until a satisfactory result is achieved. The subsequent sections of this chapter deal with each of these steps in more detail:

- Understanding the economically significant characteristics of the industry, taxpayer's business and controlled transactions
 - 5.2.1.1.1. Gathering of basic information about the taxpayer
 - 5.2.1.1.2. Transaction analysis
 - 5.2.1.1.3. Evaluation of separate and/ or combined transactions
- Examination of comparability factors of the controlled transaction
 - 5.2.1.2.1. Characteristics of the property or service transferred
 - 5.2.1.2.2. Functional analysis of the controlled transaction under examination

¹ The 2010 OECD Transfer Pricing Guidelines para.3.35 and para.3.38

- 5.2.1.2.3. Contractual terms of transaction
- 5.2.1.2.4. Economic circumstances of transaction
- 5.2.1.2.5. Business strategies of parties
- Selecting the tested party(ies) (if applicable)
- Identifying potentially comparable transactions - internal and external
- Comparability adjustments where appropriate
- Selection of most appropriate transfer pricing method
- Determination of an arm's length price or profit (or range or prices or profits)
- Documentation of comparability analysis and monitoring.

5.3. Comparability Analysis in Operation

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

5.3.1.1. Gathering of basic information about the taxpayer

5.3.1.1.1. A precursor to transfer pricing analysis is the collection of background information about the taxpayer to understand its business operations and activities. This fact-finding process should include the identification of associated enterprises involved in the controlled transaction, identification of the taxpayer's cross border controlled transactions, information about cross border controlled transactions (nature of products/ services transferred, type of intangibles used, value thereof, terms and conditions, etc.).

5.3.1.1.2. An analysis should be performed of the taxpayer's circumstances including but not limited to an analysis of the industry, competition, economy, regulatory factors and other elements that may significantly affect the taxpayer and its environment. This analysis is by nature specific to each taxpayer and industry.

5.3.1.1.3. 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 for understanding 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 in, etc.

5.3.1.2. Transaction analysis

5.3.1.2.1. 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, except in

exceptional circumstances such as where the economic substance of the transaction differs from its form, or where the arrangements viewed in their totality are not commercially rational and practically impede the tax administration from determining an appropriate transfer price. In general, restructuring of transactions should not be undertaken lightly as this would create significant uncertainty for taxpayers and tax administrations; this may also lead to double taxation due to the divergent views taken by countries on how the transactions are structured. The ability of tax authorities to do so will in any case depend on their powers under applicable domestic law. These issues are relevant for developing domestic transfer pricing legislation at the beginning of a country's transfer pricing "journey" and also to the administration of transfer pricing.

5.3.1.3. Evaluation of separate and combined transactions

5.3.1.3.1. 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 a close economic nexus.

5.3.1.3.2. 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 would not lead to a reliable result. Where transactions are so closely interrelated or continuous that application of the arm's length principle on a transaction-by-transaction basis would become unreliable or cumbersome, transactions are often aggregated for the purposes of the transfer pricing analysis.

5.3.1.3.3. Take the example of transactions involving the licensing of know-how to associated manufacturers together with the supply to the licensed associated manufacturers of components needed to exploit such know-how. In such a case, the transfer pricing analysis may be more reliable if it takes into account both the license and the supply of components together, than if it looks at each separately without recognising that they are closely interrelated transactions. Similarly, long-term service supply contracts and pricing of closely linked products are difficult to separate out into individual transactions.

5.3.1.3.4. 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 leases, sales and licenses all packaged into one deal. Generally, it will be appropriate 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 it may be more reliable to allocate the price to the elements of the package or composite contract.

5.3.1.3.5. Aggregation issues also arise when looking at potential comparables. Since third party information is not often available at the transaction level, entity level information is frequently used in practice when looking at external comparables (*e.g.* in the absence of reliable internal comparables).

(“External comparable” and “internal comparable” are defined in para 3.4.1 below). 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, applying the most appropriate transfer pricing method to the facts in that particular case.

5.3.2. Examination of comparability factors of the controlled transaction

5.3.2.1. Characteristics of the property or service transferred

5.3.2.1.1. With that background, an important step is to analyse the relevant characteristics of the property or service transferred. 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 and the volume of 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 the property. For example, comparability analysis should take into account the differences between trademarks and trade names that aid in commercial exploitation (marketing intangibles) as opposed to patents and know-how (trade intangibles).

5.3.2.2. Functional analysis

5.3.2.2.1. Functional analysis typically involves identification of ‘functions performed’, ‘assets employed’ and ‘risks assumed’ (also called “F.A.R. analysis”) with respect to the international controlled transactions of an enterprise. 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/or the profits earned from that transaction.

5.3.2.2.2. Functional analysis is the cornerstone of any transfer pricing exercise and its purpose is to gain an understanding of the operations of an enterprise with its associated enterprises and of the respective roles of the parties to the controlled transaction under examination, as these will affect the determination of an arm’s length remuneration for the transaction. This is because in transactions between two independent enterprises, compensation will usually reflect the functions that each enterprise performs, taking into account assets employed and risks assumed. The more valuable those functions, assets and risks, the greater the expected remuneration.

Functional analysis is also essential to the identification of potential comparables, as the search for the latter will generally focus on uncontrolled transactions that present a similar allocation of functions, assets and risks between the parties.

5.3.2.2.3. 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. The functions, risks and assets are analysed to determine the nature of functions performed, degree of risks undertaken and the kind of the assets employed by each party. This analysis helps to select the tested party (ies) where needed (as explained in section C below), 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 employed and risks assumed.

5.3.2.2.4. The functional analysis is important because the expected return of the entities involved in a transaction depends on the importance of the functions performed, the degree of risks undertaken and the nature and value of assets employed. Generally, the more valuable the functions performed, assets employed and risks assumed by a party to a transaction the greater its expected return (or potential loss). 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.

5.3.2.2.5. A clearer understanding of functional analysis may be gained from an example² which can be examined in detail below.

Further, hypothetical examples for illustration purposes concerning the different types of international transactions listed below are given with a view to explaining the chapter in a more practical manner. The situations are:

1. Manufacturing of products by XYZ & Co, where the technology is owned by an associated enterprise ABC & Co; and
2. Distribution by A Co of products imported from an associated enterprise B Co for sale in A Co's country.

These examples are provided in the Annex at the end of the chapter as Exhibit 1 and Exhibit 2 with a view to understand the FUNCTIONAL ANALYSIS in a more practical manner. A Co is a company incorporated and registered under the laws of Country A. A Co is the Intelligent Energy Solutions Company and is a market leader in the development, production and supply of electronic meters and their components, software, energy monitoring, billing solutions and payment systems. A Co owns technologies related to electronic energy meters. A Co is a part of Entity, the largest metering consortium in the world which shares technology and pools the extensive experience of development

²Disclaimer: Any resemblance to any case (past, present or future) is purely coincidental and the example is for illustration only as the example identifies a particular product or industry segment (electronic meters). Each FAR analysis has to be done on the facts of each individual case.

and manufacture within a network covering over thirty countries. A Co has an established marketing network in many developed and developing countries.

B Co is a company incorporated and registered under the laws of Country B and is a wholly owned subsidiary (WOS) of A Co. B Co intends to manufacture a wide range of electronic energy meters and portable calibrators, which would cater to all segments of the power generation, transmission, distribution and consumption sectors and offers similar features required for electricity revenue management. However such meters will have to be customised to cater to the needs of domestic users. Such adaptations would be carried out by B Co in its own R&D facilities.

B Co entered into a license agreement with A Co to source its core technology, TECHNO A™ - developed and patented by A Co. TECHNO A™, being software driven, allows cost effective product feature enhancements and provides flexibility to utilities to effectively manage electricity revenue and demand, thereby limiting or eliminating revenue losses. TECHNO A™ technology was developed in Country A by A Co. TECHNO A™ technology measures electricity flow using digital and microprocessor based techniques and processes the measurements into useful information. Use of TECHNO A™ technology has major advantages in the design and manufacture of meters.

With the above background in place the controlled transactions between B Co and A Co are the purchase of certain components and the license of technology from A Co. As mentioned earlier, A Co is specialised in dealing with processors and other components of electronic meters and their sub-assemblies. These are critical components of an electronic meter. B Co manufactures energy meters in Country B and uses processors and related components purchased from A Co. Post-manufacturing B Co sells energy meters to A Co, in line with its requirements. B Co has its own R&D centre which tries to increase its performance by improving the technologies so as to achieve further efficiencies. This would mean that dependence on outside sources for technologies would be reduced in future and cost savings could be achieved. Also B Co has penetrated the market in the territory of country B by incurring huge marketing expenditure to establish its own marketing intangibles. These are separate from the intangibles of A Co. in Country A for which a technology license agreement is in place with A Co.

In the following paragraphs a possible process is described on how FUNCTIONAL ANALYSIS can be carried out and documented in the given example.

For the purpose of the FUNCTIONAL ANALYSIS in the following paragraphs a qualitative description of the intra-group transactions and circumstances between A Co and B Co in relation to the purchase of components and raw materials can be described by symbols as follows:

Symbol	Comparative risk level standards	Comparative functional level standards	Comparative asset level standard
–	No Exposure	No Functions	No assets
⊙	Lowest Exposure	Least Functions	Few assets
⊙⊙	Medium Exposure	Lesser Functions	Medium assets
⊙⊙⊙	Highest Exposure	Highest Functions	Most assets

The use of these symbols provides a tool to summarize key aspects of a functional analysis, and to qualitatively compare the different enterprises in a multinational group across a number of categories related to functions, assets, and risks, based solely on the facts of a particular case. This tool, commonly referred to as a “tick chart,” is used extensively in Chapter 5 and in the Annexure to Chapter 5. Tick charts, while very useful, are inherently subjective. Accordingly, the same set of facts in the hands of two different analysts may not result in identical tick charts. Caution should be used in giving tick charts quantitative significance. For example, three ticks do not reflect three times more value than a single tick. Moreover, all categories in the chart do not have equivalent weight. Accordingly, tick charts should primarily be used as a tool in evaluating qualitative aspects of the analysis, and should not be used mechanically to split profits according to the relative number of ticks.

(a) Functions performed

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

5.3.2.2.7. 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 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, for example managerial, legal, accounting and finance, credit and collection, training and personnel management services.

5.3.2.2.8. It should be emphasised that this list is purely indicative, and that the extent to which each of these functions (or other functions not listed above) is economically significant and contributes to the creation of value depends on the industry and on the taxpayer-specific circumstances.

A typical check list is annexed to the chapter as Exhibit (3).

5.3.2.2.9. Functional analysis can be approached by evaluating all the economically significant activities performed in relation to the controlled transaction under examination (such as the list indicated above) and in potentially comparable uncontrolled transactions. In general, a taxpayer should prepare this list for both parties to the relevant controlled transaction (e.g. for the producing and selling/distributing activities) to ultimately support the selection of the most appropriate transfer pricing method.

5.3.2.2.10. Continuing the example in para 3.2.2.5, the following are the functions performed by the respective parties.

Functions performed by A Co

With respect to the sale of technology and components of electronic energy meters:

It is assumed that in the context of the sale of electronic energy meters by B Co on the basis of the technological support of A Co, A Co performs the following economically significant functions [*Caution: this example is for illustration only, and each case should be judged on its own merits*]:

- **Market development:** A Co shares its expertise with B Co and assists in developing presentations to be made by B Co to the utilities for the development of markets.
- **Product development:** A Co undertakes the product development activities based on the concept developed and offered by it to the utilities. Product development involves product engineering, designs, development or customization of microprocessors, observance of international standards and national standards for the product etc.
- **Quality control:** A Co undertakes quality control processes in order to ensure that the products manufactured by B Co conform to contractual specifications and international and national quality standards before the products are delivered to utilities and other customers. This is a critical activity because failure to ensure quality control may invite

reputational risk and product liability risk.

Functions performed by A Co in relation to the import / purchase of raw materials / components by B Co:

Functions performed by A Co with respect to the purchase of components by B Co:

It is assumed that, in the purchase of processors and other components by B Co from A Co, the economically significant functions performed by A Co can be summarized as follows : *[Caution: this example is for illustration only, and each case should be judged on its own merits]*

- *Market development;*
- *Market intelligence on technological developments;*
- *Research and development activities;*
- *Production planning;*
- *Inventory management;*
- *Manufacturing;*
- *Testing and quality controls;*
- *Selling and distribution activities;*
- *Post sales activities including replacements; and*
- *Technical assistance, wherever required.*

- **Functions performed by B Co**

It is assumed that the functions of B Co in the context of the purchase of components and subsequent sale to domestic utilities are as follows.

[Caution: this example is for illustration only, and each case should be judged on its own merits]

- *Market development:* B Co undertakes the market development activities. The market development activities primarily include development of the selling concept (i.e. identifying how the company can offer a customized solution to a utility having regard to the specific issues being faced by the utility concerned). B Co makes sales presentations to utilities and governments and liaises with them for concept selling. Based on acceptance of the concept, pilot orders for the meters are procured by B Co. It also participates in the tendering process to procure full commercial orders for the

energy meters once the pilot runs successfully. B Co also carries out activities in relation to advertisement, appointment of distributors, commission agents, sales promotion, market research and marketing strategies. Also B Co has developed the market for the new product in the territory of country B by incurring sizeable marketing expenditure to establish its own marketing intangibles that are separate from the intangibles of A Co. in Country A.

- *Research and development:* B Co has its own R&D centre which tries to boost its performance by improving the technologies so as to achieve further efficiencies, reducing dependence on outside technologies in future and achieving cost savings.

- *Production Scheduling:* The production by B Co is based on orders obtained from domestic utilities. The procurement process for the various raw materials/inputs is based on prudently prepared sales forecasts. The procurement function and the ordering processes are looked after by the 'materials department'. Factors like lead time, availability, negotiations, etc. are taken into consideration while deciding the party from which a particular raw material/input is to be purchased.

- *Tooling:* The tooling activities in relation to the products to be produced are undertaken by B Co. Different products may require different tooling. Different contract specifications may require different tooling.

- *Assembly:* This involves the assembling of components. Assembly operations are mechanical as well as manual. The activity involves mounting SMT components, manual inspection of placements of the components, computerised shouldering of mounted components, manual inspection of the shouldering process, mounting of PTA components manually, etc.

- *Intelligence loading:* Intelligence loading refers to the process of loading software and other intelligence features on the manufactured meter. B Co undertakes this activity based on the technology and microprocessor specification of the contract.

- *Testing:* Testing and quality controls are critical processes in the manufacture and marketing of electronic meters. B Co performs testing and A Co undertakes quality control measures. Testing activity involves temperature variation testing, testing of manufactured meters against standard meters etc.

- *Packaging:* B Co packs the products into specially designed containers of various sizes

depending on the consignment. The containers are in the form of cartons and pallet packaging. After packaging, products are delivered to domestic utilities.

- *Post sales activities: depending on the contracts with the customers, B Co undertakes installation and commissioning activities wherever required under the contracts. It is also responsible for the collection of payments from customers. Contractual and non-contractual product warranties are provided to customers. Any replacement or further activities required pursuant to product performance warranties are also undertaken by B Co.*

- *Inventory management: B Co is responsible for managing the procurement of raw materials/components and maintaining the requisite stock levels for the products including finished goods. As raw materials are generally product specific and the finished products are manufactured against the confirmed orders from domestic utilities, no substantial inventory management is involved.*

General Management Functions

In the above example the functions addressed below are common functions that are carried out by any business irrespective of its size and type. These functions are drivers of every business and are indispensable in the economic environment.

- *Corporate Strategy Determination: Generally, all policies within the Multi National Enterprise group are determined by the management of the respective entities which continuously monitor the economic environment surrounding the entity, assess their strategic position within the industry and set targets to achieve their corporate objectives.*

- *Finance, Accounting, Treasury and Legal Functions: The management of the respective entity is responsible for managing the finance, treasury, legal and accounting functions. Each entity is also responsible for all local statutory compliance.*

- *Human Resource Management Function: The HR function of each entity is co-ordinated by its management, which is responsible for recruitment, development and training of the personnel including the emolument structure.*

Qualitative relative assessment of functions performed by A Co and B Co with respect to B Co's market

CATEGORY	LEVEL OF INTENSITY	
	A Co	B Co
Market development	⊙	⊙⊙⊙
Product development	⊙⊙⊙	⊙⊙
Manufacturing	-	⊙⊙⊙
Quality control	⊙⊙	⊙⊙⊙
Post sales activities	-	⊙⊙⊙
<u>General management Functions</u>		
Corporate strategy determination	⊙	⊙⊙⊙
Finance, accounting, treasury and legal	-	⊙⊙⊙
Human resource management	-	⊙⊙⊙

(b) Assets employed

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

5.3.2.2.12. The analysis should involve the identification of the type of capital assets employed (e.g. plant and equipment, intangible assets, financial assets, etc.) and their significance to the controlled transaction. For economically significant assets it may be necessary to perform a more detailed analysis of the assets employed, such as their age, location, property right protections available, market value, etc.

In the 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 the entities are involved in activities for which the assets employed may not require huge capital investment. Depending on the applicable accounting standards, interest expenses are sometimes treated as operating expenses (“above the line”) or as financial expenses (“below the line”). Where interest expenses are treated as operating expenses in the accounts of the taxpayer and/or of the comparable, they will be addressed in the comparability analysis. Adjustment might be required to

ensure consistency of accounting standards between the controlled transaction and the comparable. Differences in the use of assets can be eliminated or reduced to a significant extent by making comparability adjustments on account of working capital or capacity utilization.

5.3.2.2.13. It is also essential to know which entity or entities has / have the legal ownership of the intangibles. Note that in some cases an enterprise which does not have legal ownership of an intangible may nevertheless be entitled to share in the return from its exploitation. Some countries refer to this notion as “economic ownership”. For instance, where a MNE parent has legal ownership of a product trade mark or trade name it may have to be determined, depending on the facts and circumstances of the case, whether the subsidiary has “economic ownership” of the associated marketing intangibles that are created based on the subsidiary’s contribution to a strategy to enhance market share.

5.3.2.2.14. Continuing the above example in para 3.2.2.5, the following are the assets employed by the respective parties.

Tangible assets owned by B Co

It is assumed for the purpose of the example that B Co owns the following tangible assets:

- Land & Buildings;
- Plant & Machinery;
- R&D Equipment;
- Office Equipment;
- Furniture and Fixtures;
- Vehicles;
- Computers; and
- Testing Equipment.

Intangible asset ownership

It is assumed for the purpose of the example that B Co has established a research and development department which tries to increase the level of its performance by improving technologies so as to achieve further efficiencies. This would also reduce dependence on outside sources of technology in the future and achieve cost savings. The department also conducts research and development (R&D) programmes to support B Co’s business and to provide technical assistance to its customers. These efforts help to increase production efficiency and product quality.

It is assumed for the purpose of the example that B Co has established its own marketing intangibles in Country B by incurring significant expenditure on marketing and has penetrated the market for the new product in the territory of country B. These marketing intangibles are separate from the intangibles of A Co. in country A for which a technology agreement is in place with A Co.

It is assumed for the purpose of the example that A Co is the market leader in the development and supply of electronic meters, software, energy monitoring, billing solutions and payment systems. Over

the years it has amassed a wealth of proprietary technical knowledge. This includes product specifications, designs, the latest manufacturing processes and empirical data on the usage of products by customers in the industry.

It is assumed for the purpose of the example that B Co has entered into a technology license agreement with A Co for procuring technology for the manufacture of specified products. Thus B Co uses the process, know-how, operating/quality standards etc. developed/owned by A Co. B Co leverages value from these intangibles for continued growth in revenues and profits.

It is assumed for the purpose of the example that A Co enjoys reputation for quality products. In the international utility markets, product supplies from international players from developed countries are preferred by the customers and utilities as compared to direct product supplies from suppliers located in developing countries. B Co leverages on A Co’s established brand name and reputation for high technology products. A Co’s commitment to quality also provides B Co with an edge while selling products in the domestic markets.

Summary of Assets Employed

CATEGORY	LEVEL OF INTENSITY	
	A Co	B Co
Tangible assets	⊗⊗	⊗⊗⊗
Intangible assets	⊗⊗⊗	⊗⊗
- Technological		
- Brand	⊗⊗⊗	-
- Legal	-	⊗⊗⊗
- Marketing	-	

(c) Risks assumed

5.3.2.2.15. Risk is important in the functional analysis and it should be considered together with the functions and assets. There are two important aspects to risk: how risk is created and which entity bears the risk. Risk in an MNE is created by the ownership, exploitation or use of assets, or the performance of functions over time. The next question is which entity bears the risk (see paragraph 3.2.2.17 below for a discussion of the role of contracts in risk allocation). Risk analysis involves the

identification of the economically significant risks that are assumed by each of the parties to the transaction. It is commonly understood that the bearing of economically significant risk is related to anticipation of reward.

5.3.2.2.16. In the open market the greater the economically significant risks assumed by an enterprise the higher the return that it expects, although the actual return may or may not increase depending on the degree to which such risks are realised. Conversely, in a case where such risks undertaken by the enterprise in a transaction are minimal, the return it may expect from such transactions should normally be lower. It would be expected that this would be the case in a controlled transaction that satisfies the arm's length principle.

5.3.2.2.17. An illustrative list of risks assumed by the parties to the transaction is provided below, however the relevance of each individual risk factor listed below will depend on the nature of the transaction:

Nature of risks	Particulars
1. Financial risk	<ul style="list-style-type: none"> a. Method of funding b. Fluctuation in interest rates c. Funding of losses d. Foreign exchange risk
2. Product risk	<ul style="list-style-type: none"> a. Design and development of product b. Upgrading / obsolescence of product c. After-sales service d. Risks associated with R&D e. Product liability risk f. Intellectual property risk, if any g. Scheduling risk h. Inventory risk
3. Market risk	<ul style="list-style-type: none"> a. Development of a market including advertisement and product promotion, etc. b. Fluctuation in demand and prices c. Business cycle risk d. Volume risk e. Service incentive scheme risk f. Asset redundancy risk
4. Collection risk	<ul style="list-style-type: none"> a. Credit risk

	b. Bad debt risk
5. Entrepreneurial risk	a. Risk of loss associated with capital investment b. Single customer risk c. Risk of losing human capital intangible
6. General business risk	a. Risk related to ownership of property b. Risk associated with the exploitation of a business c. Inflation risk
7. Country/regional risk	a. Political risk b. Security risk c. Regulatory risk d. Risk related to government policies

5.3.2.2.18 It should be emphasised that this list is purely indicative, and that the extent to which each of these risks (or other risks not listed above) is economically significant and contributes to the creation of value depends on the industry and on the taxpayer-specific circumstances. Hence, real life knowledge of how a particular MNE is functioning and is documented vis-à-vis its associated enterprise (AE) is very crucial in determination of the risk. For instance, not all industries involve the same level of product liability risk.

5.3.2.2.19. Risk analysis is important because comparability adjustments may need to be made for differences in risks that are assumed in a controlled transaction as compared to those in an uncontrolled transaction.

5.3.2.2.20. It is not only necessary to identify the risks but also to identify who bears such risks. The allocation of risks is usually based on the contractual terms between the parties. However, contracts between associated enterprises may not specify the allocation of all the risks. Most commonly assigned risks in the contract are controllable risks, for example inventory risk, bad debts, foreign exchange risk etc. Market circumstances, price competition, the supply of raw materials, rises in wages etc. are uncontrollable or less controllable risks, which may not be identified in the contract. Volatility in the global market in the last decade has demonstrated that these uncontrollable risks are economically more significant than controllable risks or contractual risks as mentioned above.

5.3.2.2.21. Even where a written contract is in place an analysis of the conduct of the parties is critical in order to determine whether the actual allocation of risk conforms to the contractual risk allocation. The allocation of risk under a contract will generally be respected by the tax authorities 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.

5.3.2.2.22. 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.

5.3.2.2.23. In addition, the contractual allocation of risks should be arm's length. Where there are reasonably reliable comparables evidencing a similar allocation of risks between independent parties, then the allocation of risks between the associated enterprises is regarded as being at arm's length.

5.3.2.2.24. In the absence of such comparables one relevant, although not determinative, factor that can assist in the determination of whether the allocation of risk is at arm's length is the examination of which party(ies) has (have) relatively more control over the risk. In arm's length dealings a party usually bears a greater proportion of the risk from business activities over which it exercises relatively more control. The components which may be considered to help identify the party which has control over the risk may include, when examined in relation to that particular risk:

- Core functions.
- Key responsibilities: formulation of policy, formulation of plan, budget, fixation of goals and targets etc.
- Key decisions: strategic decisions which have greater potential to impact the ability of an entity to generate profit and the amount of profits.
- Level of individual responsibility for the key decisions. Allocation of power to senior management or a level below depends upon the location of core functions in the country of the MNE or subsidiary, their contribution to core components of the various functions, their authority, their responsibility and the duties included in the employment contract of the MNE or subsidiary.

Included in the determination of whether the allocation of risk is at arm's length is the examination of which party(ies) has (have) relatively more control over the risk. This can be illustrated by following examples:

Example 1 – Control over risk by parent company

Company A situated in Country Z belongs to an MNE group having operations worldwide through various subsidiaries. Company A is responsible for the overall research programmes of the group. The group has two R&D centres operated by Companies B & C, both subsidiaries of Company A, situated in Countries X & Y respectively

Company A employs a workforce that includes the CEO, CFO, senior management and technical personnel that provides strategic supervision of the group's R&D activities. Company A claims that it controls and takes all strategic decisions with regard to the core functions of Companies B and C. Company A designs and monitors the MNE's overall research programs, provides funds needed for R&D

activities and controls the annual budget for R & D activities of Companies B & C. The CEO, CFO and other senior management personnel of Companies B and C reside in Countries X and Y and are technically and functionally competent to take decisions and carry out the R&D activities of Company B and C, under the overall direction of Company A. The technical manpower needed for R & D activity and the assets of companies B & C are located in Countries X and Y.

Company A claims that it controls the risk of the R&D activities of its subsidiaries. On inquiry in audit, it was found that the personnel managing the group's R&D activities in Company A in Country Z are technically qualified to take strategic decisions and to monitor the R&D activities of Companies B & C. It was also demonstrated that in fact substantial controls are exercised by the personnel of Company A. In addition, Company A has furnished evidence that it has covered the costs of Companies B and C's R&D activities in all the instances where such activities did not lead to successful outcomes. It was also noted that Companies B and C actually perform R&D functions and take strategic decisions required for performing the core functions of R&D.

In this example, while the actual functions of R & D activities are undertaken in Countries X and Y, Company A has demonstrated that it has the capability to control, and actually controls, the risks of unsuccessful R&D activity through its strategic decisions and monitoring activities and through bearing the losses from unsuccessful R&D programmes. Accordingly, Company A bears the risks associated with the success or failure of the research activity undertaken by Companies B and C. Companies B and C, which perform operational R&D activities and take strategic decisions to perform these core functions of R&D and also bear the related operational risk, should be entitled to an appropriate return for these functions and risks. Company A, which provides the strategic direction and management of the group's R&D activities, funds the group's R&D activities and exercises control over the risk of unsuccessful R&D activity should be entitled to an appropriate return for its functions and risks. Hence, Companies B and C as well as Company A should be entitled to an appropriate return for their functions and risks.

Example 2 – Control over risk by its subsidiaries

Company A situated in Country Z, a low tax/no tax jurisdiction, belongs to an MNE group having operations worldwide through various subsidiaries. Company B and C, which are both subsidiaries of Company A, operate R & D centres situated in Country X & Y respectively having normal tax rates.

Company A which employs a workforce of ten persons including a CEO, CFO and other senior management claims that it controls and takes all strategic decisions with regard to the core functions of companies B and C. Company A provides the funds needed for R&D activities and controls the annual budget for R&D activities of Companies B and C. It also provides technical assistance for registration of patents in Countries X, Y & Z. The CEO, CFO and other senior management personnel of Company B and C reside in Countries X and Y and are technically and functionally competent to take decisions and carry out R&D activities of Company B and C. The technical manpower needed for R & D activity and the R&D related assets of companies B and C are located in Countries X and Y.

Company A claims that it controls the risk of the R&D activities of its subsidiaries. On inquiry in audit it was found that the CEO and CFO and Senior Management of Company A in country Z are technically not skilled either to take strategic decisions or to monitor the R&D activities of company B and C. Company A has not furnished any evidence of taking strategic decisions. On the other hand, it was found that the senior management of Companies B and C are taking the important strategic decisions related to the design and direction of the R&D programme and budget. However, Company A has furnished evidence that the funds were actually transferred to its subsidiaries for R&D activities.

In this example all the core functions of R & D activities are located in Countries X and Y and the non-core functions of registering patents are located in Country Z. Even though the senior management of company A are located in Country Z they are not capable of taking strategic decisions or controlling and monitoring R & D activities. The determination, utilization and control of the budget for carrying out R&D activities and decisions regarding day-to-day performance of R&D activities were carried out by Companies B and C. In view of these facts it cannot be held that Company A controls the risk of R&D activities. Company A should be entitled to an appropriate return for the provision of funding and Companies B and C should be entitled to an appropriate return for their functions including the strategic decisions and control over the risk of R&D activities.

5.3.2.2.25. In arm's length transactions another factor, although not a determinative factor, that may influence an independent party's willingness to take on a risk is its anticipated financial capacity, at the time when risk is allocated to it, to assume (i.e. to take on) the risk. If it is anticipated that the party will not have the capacity to bear the consequences of the risk should it materialise and that it also does not put in place a mechanism to cover the risk, doubts may arise as to whether the risk would be assigned to this party at arm's length. Note that the financial capacity to assume the risk is not necessarily the financial capacity to bear the full consequences of the risk materialising (e.g. the full loss), as it may be the capacity for the risk-bearer to 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 higher risk.

Beyond the identification of these two relevant factors it is not possible to provide prescriptive criteria that would provide certainty in all situations. The determination that the risk allocation in a controlled transaction is not one that would have been agreed between independent parties should therefore be made with care considering the facts and circumstances of each case. It is pertinent to mention here that in a multinational enterprise associated entities work together to exert control over the risks of the entire MNE group. Real and precise distribution of risk among the associated enterprises is virtually impossible to achieve, due to the lack of sufficiently detailed information in some cases. 5.3.2.2.26.

Continuing the example in para 3.15, it is assumed for the purpose of the example that the following are the risks borne by the respective parties.

[Caution: this example is for illustration only and each case should be judged on its own merits.]

Risk Category	Exposure of A Co.	Exposure of B Co.
Market Risk	It is assumed that A Co. has the same level of market risk.	It is assumed that B Co. has significant exposure to this risk because it is responsible for the domestic market that it caters to.
Product liability risk	It is assumed that A Co. faces this risk arising from the product failure, technology absorption by B Co. and consequential reputational risk. Further A Co. is primarily engaged in product and technology development so this risk is also borne by A Co.	It is assumed that B Co. faces product liability risk as a result of rejection where the products do not conform to the order specification given by domestic utilities. Risks arising from non-conformity with customer specifications or national/ international product standards are borne by B Co. However, this risk is mitigated due to the excellent quality, safety standards and processes deployed by B Co. and its own R&D centre.
Technology Risk	It is assumed that A Co. is exposed to higher technology risk, being the technology owner. Due to market competition and an ever-changing technology scenario, it needs to continuously upgrade the existing technology and develop new technology to face the market competition. A Co. continuously focuses on providing products with contemporary technology.	It is assumed that the manufacturing operations of B Co. are non-complex. Further, product technology and know-how have been provided by A Co. Hence B Co. does not face any major technology risk.

Research & Development risk	It is assumed that since A Co. serves diverse markets, its engineering and R&D professionals constantly strive to provide innovative solutions that offer competitive advantages for customers worldwide.	It is assumed that since no significant R&D (except for supporting B Co's business and that of providing technical assistance to its customers) is carried out by B Co, it faces no significant risk on this account.
Credit Risk	It is assumed that in the case of inter-company sales of technology and components A Co. faces minimal risk.	It is assumed that all the major credit risks associated with sales are borne by B Co.
Inventory Risk	It is assumed that A Co. is primarily engaged in product and technology development and this risk is not borne by A Co.	It is assumed that B Co. is responsible to manage the procurement of raw materials / components and maintain the requisite stock levels for each product including finished goods. However, this risk is mitigated to the extent that components are procured from A Co.
Foreign Currency Risk	It is assumed that A Co. exports technology and components to B Co.; hence they are also subjected to appreciation/ depreciation of local currency ² against the foreign currency. Hence A Co. is also subjected to this risk.	It is assumed that since B Co. imports technology and components from A Co. and its sales are restricted to domestic markets, the imports are subjected to appreciation/depreciation of local currency against the foreign currency. Hence B Co. is subjected to this risk.

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Summary of Risks borne by each party

CATEGORY	LEVEL OF INTENSITY	
	A Co.	B Co.
Market risk	**	**
Product liability risk	-	@@@
Technology risk	@@@	@
Research & Development risk	@@@	@@
Credit risk	-	@@@
Inventory risk	-	@@@
Foreign currency risk	@@	@@

5.3.2.3. Contractual Terms of transaction

5.3.2.3.1. The conduct of the contracting parties is generally a result of the terms of the contract between them and the contractual relationship thus warrants careful analysis when computing the transfer price. Other than a written contract, the terms of the transactions may be calculated from correspondence and communications between the parties involved. In cases where the terms of the arrangement between the two parties are not explicitly defined, the contractual terms have to be deduced from their economic relationship and conduct.

5.3.2.3.2. One important point to note in this regard is that associated enterprises may not hold each other fully to the terms of the contract as they have common overarching interests, unlike independent enterprises, who 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 at more closely lacks reality, and is not valid under many legal systems) and/or have not been followed in reality.

5.3.2.3.3. Also, explicit contractual terms of a transaction involving members of an 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. In addition to an examination of these contractual terms, it will be important to check that the actual conduct of the parties conforms to them.

5.3.2.3.4. Where there are material differences in economically significant contractual terms between the taxpayer's controlled transactions and the potential comparables, such differences should be evaluated, in order to judge whether comparability between the controlled and uncontrolled transactions is nevertheless satisfied and whether comparability adjustments need to be made to eliminate the effects of such differences.

5.3.2.3.5. An example of how contractual terms may 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, the 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 the 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, volume discount if any, 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.

5.3.2.4. Economic circumstances of the transaction

5.3.2.4.1. Economic analysis deals with industry analysis and the circumstances that may be relevant for determining market comparability. The relevant information on the industry can be broadly classified into following:

- 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; and
- Market position of the enterprise and surrounding economic conditions.

Care must be exercised while considering global economic trends, as the market trends in the taxpayer's country and in the country of its associated enterprise and/or of the potential comparables (in the case where foreign comparables are used) could be significantly different. For example in the 2008 meltdown of the global economy some of the banks and automobile companies reported huge losses globally, but significant profits in emerging economies. Where there are such significant differences between the economic circumstances prevailing in different markets such that it is not possible to eliminate them by making reliable comparability adjustments, then companies from such different markets might not be retained as reliable comparables.

5.3.2.4.2. Undertaking a more detailed classification of the above broad headings would yield the following specific factors which may need to be looked at in performing an industry analysis if they are economically significant for the examined controlled transaction:

- Geographic location of the market;
- Market size;
- Level of the market (e.g. retail or wholesale);
- Competition in the market and the relative competitive positions of the buyers and sellers;
- Availability of substitutes;
- Government regulations of the market;
- Levels of supply and demand;
- Consumer purchasing power;
- Location-specific costs of production including the costs of land, labour, capital, transportation costs etc.;
- Economic conditions of the overall industry, the key value drivers in the industry and the date and time of transactions;
- The existence of a cycle (economic, business, or product cycle); and
- Other relevant factors.

5.3.2.4.3. Market prices for the transfer of the same or similar property may vary across different markets owing to cost differentials and/or differences in purchasing power and habits prevalent in the respective markets which may affect 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 discussed below.

5.3.2.4.4. Geographical location – in general, uncontrolled comparables 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) there are no differences between the two markets that would materially affect the price or profit of the transaction or (ii) reasonably reliable adjustments can be made to account for such material differences between the two markets.

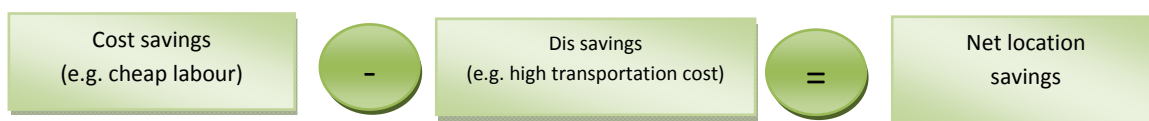
5.3.2.4.5. An example of a potential issue relating to geographic location is that of location savings, which may come into play during a transfer pricing analysis. Location savings are the net cost savings that an MNE realises as a result of relocation of operations from a high cost jurisdiction to a low cost jurisdiction. Typically, the possibility to derive location savings may vary from one jurisdiction to another, depending for example on the following:

- labour costs;
- raw material costs;
- transportation costs;
- rent;

- training costs;
- subsidies;
- incentives including tax exemptions; and
- infrastructure costs.

It is quite possible that part of the cost savings may be offset at times by “*dis-savings*” on account of poor infrastructure in relation to the quality and reliability of the power supply, higher costs for transportation, quality control etc. Accordingly, only the net location savings (i.e. savings minus dis-savings) may give rise to an extra profit arising to an MNE due to the relocation of its business from a high cost to a low cost jurisdiction.

5.3.2.4.6. How are location savings measured: The computation of location savings typically involves the quantification of the net cost savings derived from relocating in a low cost country, as compared to the relevant high cost country. In theory, the cost savings computation includes selection of a pre-transfer manufacturing or servicing base in the relevant high-cost country compared to the comparable manufacturing or services cost in the low-cost country, taking into account such things as total labour cost per unit of output (adjustment on account of difference in labour productivity), cost of raw material, costs of land and rent costs; tax benefits etc. The cost savings can be partially offset by higher cost of infrastructure like less reliable power etc. in certain cases.

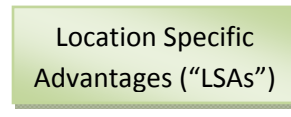
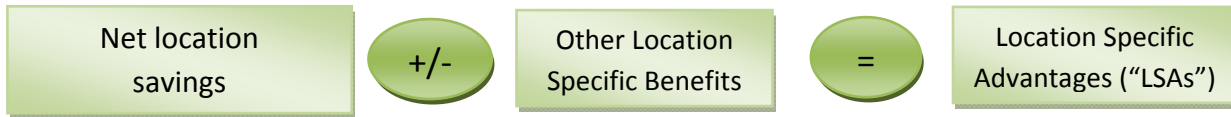


5.3.2.4.7. What are location-specific advantages: The relocation of a business may also (in addition to location savings) or alternatively give some other location-specific advantages (in short LSAs). Location savings and location specific advantages are one type of benefit related to geographical location. These LSAs could be, depending on the circumstances of the case:

- highly specialized skilled manpower and knowledge;
- proximity to growing local/regional market;
- large customer base with increased spending capacity;
- advanced infrastructure (e.g. information/ communication networks, distribution system); or
- market premium.

Taken together, location savings and each of the other types of benefit related to geographical location are called location-specific advantages [LSAs]. LSAs may play a very important role both in increasing the profitability of the MNE and in determining the bargaining power of each of the associated enterprises. It should be noted that the term LSA includes sources of value that are discussed elsewhere in the Manual, and should not be double counted in assessing arm’s length outcomes.

LSAs can be measured as under:



What is location rent?

5.3.2.4.8. The incremental profit, if any, derived from the exploitation of LSAs is known as “location rent”. Thus, the term “location savings” represents “cost savings” whereas “location rent” represents the incremental profits derived from LSAs. The value of “location rent” is at most equal to, or less than, the value of LSAs.



5.3.2.4.9. What determines whether LSAs lead to location rents? The extent to which LSAs will lead to location rents depends on competitive factors relating to the end product and to the general access to LSAs. It is possible that in a particular case, even though LSAs exist, there are no location rents. For example, in situations in which the market for the end product is highly competitive and potential competitors also have access to the LSAs, much or all of the benefits of LSAs would be passed on to the customers through lower prices of products, resulting in little or no location rents. However, circumstances where extra profits are passed on to customers are varied, and may be permanent or temporary. Where this is temporary, at the end of this period of competition, the MNE may possibly achieve a larger market share in the local market with an increased ability to sell products at a higher price. Alternatively, if an MNE has exclusive access to the LSAs, then the MNE may derive significant location rents associated with the LSAs, as the LSAs reflect a competitive advantage. These location rents may dissipate over time due to competitive pressure, depending on the facts and circumstances of each case.

5.3.2.4.10. As with the determination of whether location rents exist, the arm’s length attribution of location rents depends on competitive factors relating to access to the LSAs, and on the realistic alternatives available to the associated enterprises given their respective bargaining power. To the extent that competitors would not have access to the LSAs, the relevant question is why this is so. There are a number of possibilities. For example, the MNE could have production intangibles that allow it to manufacture at a lower cost than competitors. At arm’s length, the owner of the intangible would typically be entitled to the rents associated with this cost saving, as it would have a realistic alternative

to undertake its production elsewhere at similarly low costs. As another example, it might be that the low-cost producer is the first to operate in the low cost jurisdiction and there are no comparable low-cost producers in its or other jurisdictions, implying that, for a time at least, it is well-placed to extract a part of the location rents.

The next question would be what constitutes an appropriate split consistent with arm's length principle? As discussed above, the bargaining power of the associated enterprises which reflects the arm's length nature of two independent parties negotiating over their respective shares of savings/rents may be well suited. This can be used to determine the arm's length surplus (savings/rents) allocations when comparable uncontrolled transactions or benchmarks are not available.

5.3.2.4.11. 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 if they apply in the same way to controlled and uncontrolled transactions. In the ordinary course of events 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 between associated enterprises are consistent with comparable uncontrolled transactions between independent enterprises.

5.3.2.4.12. 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 (E.O.U.'s) which may be subject to beneficial provisions under the taxation laws of a country; ideally companies that 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. Another example is where foreign exchange regulations limit the amounts of the payments that can be made for services or intangibles. However, such regulatory limits may not set arm's length prices for services or intangibles.

For example, assuming that all the transactions are in the same currency, certain countries have restrictions on the payment of interest on external commercial borrowings and the exchange control regulatory requirements authorise the borrower to pay interest at LIBOR plus say 200 basis points. The country of the lender may however not agree to use this as a basis for benchmarking the transaction when the lending enterprise itself borrows in its domestic market at a higher rate than LIBOR plus 200 basis points.

5.3.2.4.13. Level of Market – for example, the price at the wholesale and retail levels would generally differ.

5.3.2.4.14. 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; the size of the market and the extent of competition.

5.3.2.5. Business strategies

5.3.2.5.1. On a general level business strategies are one of the important factors in comparability analysis. However, the examination of the legitimate business strategy of an MNE will depend on the facts and circumstances of each case. The business strategy of an MNE is dependent upon the structural characteristics of an industry. Nonetheless, MNEs with different business strategies do exist within the same industry. In fact, the business strategy of MNEs may differ due to their different global integration - local responsiveness pressure, different corporate histories, internal efficiencies and competitive advantages. Business strategies would take into account many aspects of an enterprise such as innovation and new product development; degree of diversification; risk aversion; assessment of political changes; impact of existing and planned labour laws; duration of arrangements and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions of the enterprises. However, the ultimate objective of a business strategy of an MNE is to improve its market share and/or overall profitability.

5.3.2.5.2. On a strategic level market share improvement strategies considered by MNEs can be divided into the following three main categories depending on the period of their existence in a market:

- market penetration strategy;
- market expansion strategy; or
- market maintenance strategy.

The above market share strategies depend on various factors like market power and the business life cycle of the MNE in a particular market. Market penetration occurs when an MNE is a relative newcomer to a particular market and is seeking to enter and establish its products/services in the new market. An MNE might actively pursue a market expansion strategy to increase market share in highly competitive market. The market maintenance occurs when an MNE has already entered a market and is required to maintain its market share.

5.3.2.5.3. A market penetration strategy may involve a combination of strategies for:

- attracting existing users of a competitive brand to new products; and
- attracting non users to the product category to which the new product belongs.

5.3.2.5.4. When an MNE pursues a market maintenance/expansion strategy it may focus on a combination of the multiple strategies of:

- attracting users of competitive brands;
- pursuing current users to increase usage; and

- attracting non users of the product category.

All these three market share strategies use two fundamental tactics:

- lowering the price of their products on a temporary basis by offering discounts on the product to become extremely competitive in the market; and
- increasing their marketing and selling expenses through increased advertisement; sales promotion activities like offering rebates, free samples, offering extended warranties etc. and increased marketing activities like more salesmen, commission agents or distributors and increased payments of commission to distributors.

It may be desirable to isolate the costs related to the pursuit of the above referred tactics as precisely as possible so that the allocation of costs at arm's length can be computed.

5.3.2.5.5. Although market penetration, market expansion and market maintenance strategies are legitimate business strategies these may involve substantial costs, sometimes resulting in significant losses. Accordingly, there is strong implicit recognition that market share strategies cannot be pursued indefinitely by a taxpayer and there has to be some definite time frame in the foreseeable future when these strategies might yield future profit. The allocation of the costs of these strategies between an MNE and its subsidiaries is an important issue in transfer pricing and will depend on the facts and circumstances of each case. It is important to examine the following factors in order to address this issue of cost allocation between parties to the transactions:

- which entity is the initiator of the strategy;
- which entity is the intended beneficiary of the strategy;
- whether unusually intense advertising, marketing and sales promotion efforts are taking place since these would provide a signal of market penetration or market share expansion strategies;
- the nature of the relationship between related parties, i.e. their responsibilities and risk profile;
- whether the strategy involves intangibles; and
- which party is the legal and economic owner of such intangibles.

For example, a limited risk company acting solely as a sales agent with little or no responsibility for market development would generally not bear the costs of a market penetration strategy initiated by its parent company.

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5.3.2.5.6. When an MNE enters a new market with its product or expands market share of its product in an existing market through its subsidiary, questions of the creation of marketing intangibles

and increases in the value of product-related intangibles such as trademarks, trade names etc. follow closely behind. Therefore, it is quite important to examine and follow the process of creation of intangibles in a market, as well as the legal ownership of that intangible and the right to share in the return from that intangible (the notion which some countries refer to as “economic ownership”). It is recognised that market research; designing or planning products suitable to market needs; advertising; marketing and sales promotion strategies; after-sale services and networks of dealers and sales/commission agents may contribute to the creation of marketing intangibles depending on the facts and circumstances of each case.

5.3.3. Selection of the tested party

5.3.3.1. 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 transaction(s) will influence the selection of the tested party (where needed). The tested party normally should be the less complex party to the controlled transaction and should be the party in respect of which the most reliable data for comparability is available. It may be the local or the foreign party. If a taxpayer wishes to select the foreign associated enterprise as the tested party, it must ensure that the necessary relevant information about it 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.

5.3.4. Identification of potentially comparable transactions or companies

5.3.4.1. Uncontrolled comparable transactions (“comparables”) are of two types:

- (a) Internal comparables, i.e.** 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.** transactions between two independent parties, neither of which is a party to the controlled transaction.

(a) Internal comparable

5.3.4.2. Even though internal comparables may possibly display a higher degree of comparability there is a need to subject internal comparables to as rigorous a scrutiny as external ones with regard 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 this will require careful consideration of the facts and circumstances of each case.

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 the use of identical accounting standards.
- ii. Transaction-specific financial and other information is 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.

A Caution:

- i. Potential internal comparables may not necessarily be 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.

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

5.3.4.4. However reliable internal comparables often do not exist to cover the broad scope of the controlled transactions under consideration. Thus, the taxpayer often needs to examine external sources of potential comparable transactions among third parties.

(b) Third-party comparable / External comparable

5.3.4.5. There are two types of third party or external comparable. The first type relates to transactions between two independent parties, neither of which is a party to the controlled transaction. For example, it might be possible to apply the CUP method based on the price of a comparable product sold under comparable circumstances by uncontrolled parties.

5.3.4.6. The second type of third party or uncontrolled comparable relates to comparable uncontrolled companies, for example in the application of profit based methods.

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

- B.1 Examination of the five comparability factors for the controlled transaction;
- B.2 Development of comparable search or “screening” criteria;
- B.3 Approach to identifying potential comparables;
- B.4 Initial identification and screening of comparables; and
- B.5 Secondary screening, verification and selection of comparable.

5.3.4.7. 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

5.3.4.8. The examination of the five comparability factors is described in Section B above. It will help both in understanding the taxpayer's controlled transaction to select the most appropriate transfer pricing method and in developing search criteria to identify comparables in order to apply the selected method.

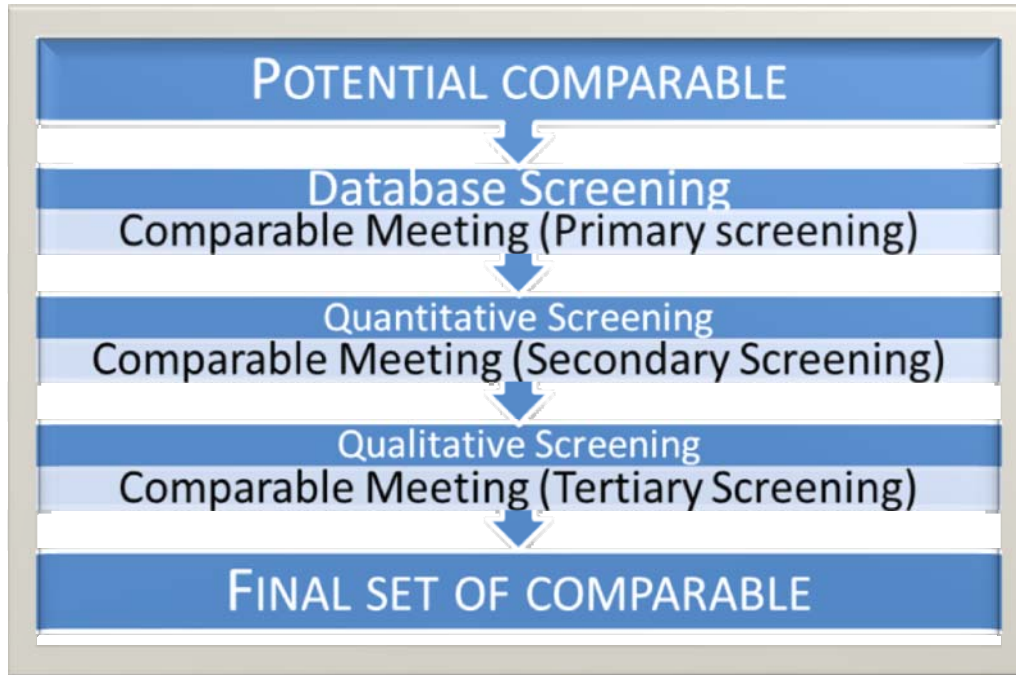
B.2 Development of comparable search or "screening" criteria

5.3.4.9. Comparable search or "screening" 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 satisfy comparability vis-à-vis the controlled transaction and the tested party.

5.3.4.10. 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 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.

5.3.4.11. A typical process of comparable search may be divided into three screening phases, namely database screening (primary screening), quantitative screening (secondary screening) and qualitative screening (tertiary screening).

Figure 1: Typical Screening Process



In each of these phases comparables are reviewed in order to determine whether they qualify as comparables for possible inclusion or rejection. The database screening is generally applied with regard to industry code, geographic location, level of market, business mix, scale of operations, independence and financials. The quantitative screening often involves screening the financial information relating to the potential comparables for the relevant period to determine whether they have comparable financial information or report sufficient operating profit data. However, qualitative screening is mostly used by applying various financial ratios (referred to as diagnostic ratios) to the remaining potential set of comparables. The qualitative screening is generally performed by diagnostic ratio to reject or accept comparables based on the qualitative information available. After the qualitative screening has been performed the final set of comparables remains. 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:

Geographic, product/service market

5.3.4.12. Independent companies operating in the same market(s) as the tested party, where available, will generally be preferred. However in many countries, especially developing countries, the availability of independent comparables, or of public information on independent comparables, is limited. Use of foreign comparables may therefore be needed, although this can also be difficult for

many developing countries without access to relevant databases and with limited resources to analyse and adjust the foreign comparables.

Mix of functions, level of market

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

Business mix

5.3.4.14. Typically companies engaged in significant business activities that are substantially dissimilar to the controlled transaction and are not adequately disclosed to allow segmentation should be excluded from the set of comparables.

Scale of operations

5.3.4.15. Comparables must be selected so that their financial performance reasonably reflects the scale of economies of the controlled party, depending upon the nature of the business. 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 affect comparability.

Independence

5.3.4.16. Only uncontrolled transactions can be used as comparables. However, companies having small associated party transactions which do not materially affect their gross or net margin may still be used as uncontrolled comparables.

Financial disclosures

5.3.4.17. Public or private companies reporting in a reasonably standard format with detailed 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 of the regulatory agencies around the world require filing of audited financial statements that conform to their generally accepted accounting principles. Also public companies provide considerably more detail in their audited 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 a multi-year statistical analysis that can be applied in prospective pricing decisions.

Relevant period

5.3.4.18. External comparables must be selected such that the relevant operations and available financial data appropriately reflect the business cycle and general economics of the year or period at issue. Contemporaneous transactions are most likely to reflect similar economic conditions and ensure a higher degree of comparability. However there can be exceptions to the above general rule, and multiple year data may also be considered if such data reveals facts which could have an influence on the determination of transfer pricing in relation to the transactions being compared.

5.3.4.19. Examining multiple year data may be useful in a comparability analysis but it is not a systematic requirement. Multiple year data may be used where they add value and make the transfer pricing analysis more reliable. Circumstances that may warrant consideration of data from multiple years include the effect of business cycles in the taxpayer's 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.

Diagnostic Ratio:

5.3.4.20. The search for comparables may be aided by a quantitative screening tool using diagnostic ratios. Diagnostic ratios are financial ratios applied to reject comparables that do not fulfil certain criteria. If used, quantitative screening should be applied to improve the reliability of the set of comparables.

5.3.4.21. The application of diagnostic ratios is based on the assumption that a diagnostic ratio constitutes a value driver of a particular line of business and is a reflection of the comparable functional and risk profile. Most of the countries having transfer pricing rules acknowledge that the application of a net margin method is less sensitive to product and functional similarity than a traditional transaction method. However, functional comparability is still required in practice. Diagnostic ratios enable some of the features of a potential comparable that are economically relevant for the comparable search process to be taken into account when performing the comparable search.

5.3.4.22. In order to identify potential comparables with a similar functional and risk profile a diagnostic ratio measuring for example the level of wage costs compared to an appropriate base (e.g. total operating costs or total turnover) can be used as a yardstick to measure the level of technical manpower employed by comparable companies engaged in software development. The identification of a diagnostic ratio will depend upon several factors like geographical location; the nature of the business, product and services; the product and service market etc. Using diagnostic ratios may help to identify comparables which are in line with the functional and risk profile of the tested party.

5.3.4.23. The diagnostic ratio is applied by using cut-off criteria. In this method financials of the tested party are used to calculate the diagnostic ratios and these ratios are then used to create minimum or maximum values to reject companies. Once a cut-off is determined, generally all the values above or below a particular range of the cut off will be eliminated, depending upon the facts and circumstances of each case. Subsequently, based on the functional and risk profile of the tested party, all companies with a diagnostic ratio above and below the cut-off range will be excluded.

B.3 Approach to identifying potential comparables

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

5.3.4.25. In the additive approach a list is prepared of potentially comparable uncontrolled transactions or of third parties which are believed to be carrying out potentially comparable transactions. The taxpayer then collects as much information as possible on these transactions to confirm whether they are in effect acceptable comparables, based on the five comparability factors for the controlled transaction. When adopting the additive approach one may take special care that in order to provide a reliable comparable it is not sufficient that a third party company be well-known in the relevant industrial sector. Also, one needs to avoid potential third party companies who themselves have transfer pricing issues.

5.3.4.26. 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. The approach typically starts with a wide set of companies that operate in the same sector of activity, perform similar broad functions, and do not present economic characteristics that are obviously different.

5.3.4.27. It needs to be emphasised here that exclusive use of either of the two approaches may not yield valuable results. Depending on the facts of each case, one of the above two approaches can be used or both in combination.

5.3.4.28. In combining the “additive” and “deductive” approaches one may find that companies are identified from the additive approach that 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.

5.3.4.29. It is very important that the taxpayer or tax administration using the “additive” and / or “deductive” approaches justifies and documents the criteria used to include or exclude particular third party data from the pool of potential comparables, in order to ensure a reasonable degree of objectivity

and transparency in the process. In particular, the process should be reproducible by the taxpayer and by the 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 in a database under a given industry code.

B.4 The deductive approach: Initial identification and screening of comparables

5.3.4.30. 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 evidence of market pricing or profits. 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 information sources other than databases this part of the process may be different.

5.3.4.31. The process of screening, verification and selection of comparables will largely depend upon the availability of databases in the public domain in the country. Public databases may be available in some countries whereas other countries may not have these databases. In such cases, one of the options could be to rely on a database from a comparable economy with reasonable and reliable adjustments.

5.3.4.32. However, the following analytical needs and constraints should be kept in mind:

- The searching process should avoid any systematic biases;
- The screening process must be executed and documented in a manner consistent with the general requirement for due diligence; and
- 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

5.3.4.33. Under this step the search process focuses on a rigorous review of each transaction or 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.

Information sources for third-party or external comparables

5.3.4.34. The taxpayer may have to 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 the 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.

5.3.4.35. There are various sources of data and information which are available to assist a taxpayer or tax administration in identifying potential comparables. Possible sources range from electronic databases to regulatory and other government filings and 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 criteria.

5.3.4.36. The data sources provide 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 comparables are ultimately selected. Others provide business profiles and detailed financial information about potential comparables. Each source can be important in establishing and documenting the quantitative basis for an arm's length transfer pricing policy.

(a) Electronic data compilations

5.3.4.37. Among the general sources of information are databases which have been developed by various organizations which compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. Some of these databases compile financial data from one country only, while others compile regional or even global data. These products typically provide detailed financial information as well as some textual information such as short business descriptions, although the level of detail largely depends on the country concerned.

5.3.4.38. 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 potential comparables that meet certain qualitative and quantitative screening criteria. Criteria commonly used for initial screening include industry codes, scale or sales volume, ownership and related/associated enterprises, availability of financial data or certain financial ratios.

5.3.4.39. Criteria commonly used for initial screening may include inter alia:

- i. geographic restrictions with respect to a country or region;
- ii. a specific industry classification;
- iii. certain keywords;
- iv. elimination of all those enterprises which may have substantial transfer pricing issues themselves and fail an independence screening;
- v. inclusion or exclusion of specific functions such as research and development, production, distribution or holding of shares;
- vi. exclusion of companies which were only recently set up;
- vii. consideration of 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. a focus on sales volume, fixed assets or numbers 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.

5.3.4.40. 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 format, making it difficult to compare. Most of these databases are used to compare the results of companies rather than of transactions because third-party transactional information is generally not readily available.

5.3.4.41. 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 and commercial databases are not available in all countries. Further they may be costly to use and many developing countries may not have access to them. The use of commercial databases is not compulsory and it may be possible to identify reliable comparables from other sources of information, including internal comparables as described above, or a manual identification of third parties (such as competitors) that are regarded as potential sources of comparables for the taxpayer's controlled transaction.

(b) Other comparable data sources

5.3.4.42. There are other data sources available to provide more detailed business mix, product line, geographic market, functional mix and ownership information on the first-round selection of

potential comparables as well as to identify additional companies that should be considered. These sources 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 these institutions or organisations will maintain databases and research reports, and/or hold files with data on potential comparables. Generally these institutions or organisations would be:
 - Chambers of commerce;
 - Trade and professional organizations;
 - Embassies, consulates or trade missions; or
 - International organisations (e.g. United Nations agencies, the Organisation for Economic Cooperation and Development, the World Bank, the International Monetary Fund).

5.3.4.43. For a clear understanding of screening we may consider an example which can be examined in detail in the paragraphs below.

X Co is a 100% subsidiary of the Y based software company Y Co which is in the business of information technology to create innovative software solutions for financial, pharmaceutical and technology companies.

X Co is a captive service provider related to software development and maintenance solutions for the parent company. From this discussion it is clear that X Co has only one type of international transaction with the related party, namely, the provision of offshore software development services.

Functions performed³

Description of functions	X Co	Y Co (AE)
Products R & D, design and concept	-	@@@
Testing of the product	®	@@@
Marketing function	-	@@@

³ The following is a summary of the FAR analysis relating solely to X Co's activities (provided for illustration purposes only); each particular case should be judged on its own merits.

Service function	@@	@
After-sale function	-	@@@
Accounts function	@@@	-
Description of functions	X Co	Y Co (AE)
Products R & D, design and concept	-	@@@
Testing of the product	@	@@@
Marketing function	-	@@@
Service function	@@	@
After-sale function	-	@@@
Accounts function	@@@	-

Assets employed relating to X Co's operations

Description of assets	X Co	Y Co (AE)	Comments
Skilled workforce	@@@	-	
Property, plant and equipment	@@@	@	
Intangibles	-	@@@	Any technical knowledge acquired during projects is retained in the country of X Co. The Y Co trademark is not registered in country of X Co.

Risks assumed

Description of risks	X Co	Y Co (AE)	Comments
Credit risk of customers	-	@@@	Y Co (AE) raises invoices on the end clients. Hence, AE assumes risk of collection from the clients.
Service level quality risk	@@@	-	
Working capital risk	-	@@@	X Co is compensated by the AE in advance and hence, is not required to seek finance to fund its working capital.
Foreign currency risk	@@@	-	
Material risk	-	@@@	
Software technology risk	-	@@@	
Human capital risk	@@@	-	

Since the controlled transactions of X Co are being tested it is taken as the Tested Party. Further it is assumed that searches for potentially comparable companies were conducted on the publicly available data sources.

The steps in the selection process can be summarized as follows (table provided for illustration purposes):

Criteria	Number of companies passing the criterion	Explanation
<u>Company's main economic activity</u>	<u>764</u>	<u>Company primarily engaged in providing computer software, and software services and consultancy</u>

<u>Financial data March 2007 onwards</u>	<u>411</u>	<u>Companies where the latest data is not available have been excluded</u>
<u>Sales > US\$ 10 million</u>	<u>280</u>	<u>To eliminate companies whose sales are less than US\$ 10 million</u>
<u>Wages to sales⁴</u>	<u>157</u>	<u>To eliminate companies whose wages to sales are less than or equal to 25%</u>
<u>Qualitative analysis</u>	<u>8</u>	<u>Companies which fall under the category of “different line of business activity”, “related party transactions”, “loss making” (an average loss over a 3 year period) and “data unavailable for review” were not considered.</u>

5.3.5. Adjustments to Comparables: “comparability adjustments” (where appropriate)

Certain adjustments may be needed in order to satisfy the requirements for accuracy and reliability of the comparables so that the financial results of the comparables are stated on the same basis as those of the tested party. However, the following important issues may be considered before an adjustment is made:

- Quality of data being adjusted: the comparability adjustment may only be applied where it can improve the reliability of comparables. If the search process for comparables has major shortcomings adjustments may not be applied to poor comparables which would require too many adjustments;
- Purpose of adjustment performed: differences that have no material effect on comparability should not be adjusted;
- Not every transaction being compared is capable of being adjusted: there are transactions that may be adjusted but some other transactions like those concerning goodwill or intangibles may not be capable adjustment;
- Reliability and accuracy of the adjustment: the adjustment should be calculated based on objective and verifiable data; and
- Documentation: comparability adjustments are part of comparability analysis and should be appropriately documented in order to ensure its reliability.

Comparability adjustments can be divided into the following three broad categories:

⁴ This criteria is used here as the example is that of a company engaged in the provision of services, which assumes the need for a significant work force. Wages are therefore a major factor in the revenue earned, and thus these criteria can be used in specific situations in the process of elimination.

Accounting adjustments:

5.3.5.1. There are various types of difference in accounting standards and practices between the tested party and third parties used as comparables which may lead to measurement errors if adjustments are not made.

The accounting differences could be grouped under following categories:

5.3.5.2. Classification differences: accounting differences may relate to classification where certain operations are recorded in different accounting lines. For example:

- A sales rebate granted to a customer may result in an adjustment to sales or recorded as negative sales or marketing expenses depending upon accounting practice, and this may affect gross margins (resale price method);
- R & D expenditure may be reflected either in operating expenses or in the cost of sales, thus gross margins are not comparable and this requires appropriate adjustment (cost plus method); or
- Similarly the lack of a clear distinction between direct costs and indirect costs affects gross margins. Many of these classification differences are eliminated by applying the TNMM. However, even when using TNMM on a net margin level some accounting differences may exist which can affect net margin in the same way as gross margins resulting in differences between the tested party and comparables, for example different depreciation periods, treatment of employee's stock options etc.

5.3.5.3. Accounting differences under relevant law or standards: a comparable or tested party may have a choice under relevant law or standards to capitalize or expense certain costs like R&D expenses. Thus, a company may have developed significant intangibles but have no intangible property in its assets on the balance sheet. Similarly, different accounting law or standard may be applicable to goodwill recognition and amortization which may create significant discrepancies between the comparables and the tested party. In many cases it is difficult to identify differences in accounting standards due to the following reasons:

- limited amount of detail available with regard to comparables in the public domain;
- potential inconsistencies in the reporting of company financial data by private reporting services;
- inconsistencies among methods of reporting among companies; and
- different accounting standards followed in different countries.

Balance sheet Adjustments

5.3.5.4. The balance sheet adjustments are intended to account for different levels of inventories, receivables, payables, interest rates, etc. The most common balance sheet adjustments, made to reflect differing levels of accounts receivable, accounts payable and inventory, are known as working capital

adjustments. The fact that balance sheet adjustments are found most commonly in practice does not mean that they should be performed on a routine or mandatory basis. A significant different level of asset intensity may require further investigation of the comparability characteristics of the potential comparable and merely making a working capital adjustment would not alleviate the problem.

Working capital adjustment

5.3.5.5. It is very common for the tested party and each of the potential comparables to differ materially in the amount of working capital (inventory, accounts receivable and payable). Such differences are generally caused by differences in the financing terms of purchases and sales that the company receives from its suppliers and extends to its customers, and by differences in the levels of inventory held by the company. Such differences may generate substantial differences in the working capital structure and may have an impact on the operating profits of the companies due to the financing costs. In order to reduce the effect of differences in terms of purchases and sales and levels of inventory on profitability, adjustments can be made to reflect the time value of the receivables, payables, and inventory of the comparables. This, however, should be done only if such adjustments can be reasonably made and they improve comparability.

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

In the following hypothetical example the comparable's results are adjusted to reflect the tested party's levels of working capital. The other approach could be that calculations are made to adjust the tested party's results to reflect the comparable's levels of working capital or to adjust both the tested party's results and the comparable's results to reflect "zero" working capital.

Generally working capital adjustments are calculated for inventory, trade receivables and trade payables. The method for calculating working capital adjustments for all three accounts follows the same basic mechanics. To start with, a value is calculated for differences in levels of working capital between the tested party and the comparable party relative to the appropriate base. The appropriate base will be the denominator used for calculating the PLI which can either be costs, sales or assets. The resulting difference in the ratios is then multiplied by an appropriate interest rate. A working capital

(WC) adjustment so computed is either adjusted to the comparable's PLI or to the Tested Party's PLI for the purpose of comparison.

Formula –



The following Illustration is hypothetical. This is provided only to demonstrate how a working capital adjustment can be calculated. Furthermore it should not be construed as the only way in which such an adjustment may be calculated.

Particulars	Tested Party	Comparable Party
Sales (A)	100	120
EBIT (B)	5	7
Operating Profit Margin (PLI) (A/B in %) (C)	5%	5.8%
Net Working Capital ('NWC')		
Accounts Receivable (D)	100	110
Inventory (E)	20	40
Accounts Payable (F)	50	50
Net Working Capital (G) (D+E-F)	70	100
Net Working Capital to sales	70%	83.3%
Difference between Net Working Capital to Sales of Tested and Comparable Party (H)		-13.3%
Interest Rate on NWC (I)		5%
Adjustment (J) (I*H)		-0.7%
Working Capital Adjustment –		5.1%
Re-computing the PLI for the Comparable (C-J)		

Other Adjustments:

5.3.5.7. This category of adjustment is proposed by the taxpayer or tax administrator to adjust for specific economic circumstances that affect the transactions being compared. There can be significant differences in the mix of functions performed by the potential 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 may affect the reliability of the comparables in establishing an appropriate arm's-length profit range.

5.3.5.8. To eliminate the effect of such differences the financial results of the comparables may need to be adjusted. Such adjustment is possible only when reliable and accurate segmented detailed information is available. An adjustment is made to the revenue and costs relevant to the functions performed by the comparables but not by the tested party. If we find an arm's length return for additional functions performed by the tested party, then we need not adjust the comparables, but we simply apply that arm's length return based on another set of comparables to the tested party for those functions. Care should be exercised while making a functional adjustment which involves a subjective assessment.

5.3.5.9. There can be significant differences in the mix of functions performed by the potential comparable vis-à-vis the tested party. 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 (notwithstanding that the independent distributors have been determined to be the best available comparables), performs only first-tier distribution functions and performs limited manufacturing and assembly functions. To adjust for such differences the financial results of the comparable may be adjusted to account for the revenue, costs, and associated profits associated with the functions performed by the comparable but not by the tested party, or vice versa. For example, consider adjustments performed to adjust for material differences in the mix of functions performed by a controlled storage device distributor and a set of independent storage device distribution comparable. Assume that the independent device distributors (determined to be the best available comparables) 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 profits associated with manufacturing / assembly operations and with downstream distribution functions based upon the profitability earned in uncontrolled comparable storage manufacturing and downstream distribution transactions. In other words, for comparability purposes, only the functions comparable to the functions carried out by the controlled storage device distributor should be taken into consideration. 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 adjusted to reflect an arm's length profit associated with these functions.

***i.* Presence of significant intangibles**

5.3.5.10. Where a significant part of the potential comparable's profits is attributable to significant, unique intangibles, such as unique product design or unique 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 comparable may need to be rejected.

***ii.* Risk adjustment**

5.3.5.11. As discussed earlier (in para 3.24 to 3.33) economically significant risk is related to anticipated reward and it would be expected that this would be reflected in a controlled transaction that satisfies the arm's length principle. However, the actual return may or may not increase depending on the degree to which the risk is actually realised. As such, similarity in the level of risk is an important consideration in selecting comparable.

5.3.5.12. The degree of comparability between a tested party and an uncontrolled taxpayer is impaired when the entities assume different economically significant risks which may require making a risk adjustment. For example a contract manufacturer in certain circumstances does not usually assume the market risk that full-fledged manufacturers customarily do.

5.3.5.13. There is no universally accepted method for risk adjustment. However, in practice MNEs carry out risk adjustment through application of certain methods that attempt to quantify on an ex ante basis the effect of risk on anticipated profitability based on, for example, the weighted average cost of capital /capital asset pricing model. However it is worth mentioning that both models are based upon risk models used mainly in relation to the risk of securities. Most statistical methods have their inherent known limitations. Therefore risk adjustment must be made carefully and only if a reasonable and accurate adjustment is possible.

***iii.* Adjust for differences in transactional structure between the comparable and the tested party**

5.3.5.14. It has to be recognised that problems can arise due to significant differences in the transactional structure between associated party sales in a controlled company and similar transactions involving independent companies.

5.3.5.15. These problems typically arise in controlled situations when the parties allocate the risks and functions of the enterprise among themselves in a different way from the allocation of risks and functions between independent enterprises. The differences in the bargaining power and degree of common interest of the associated parties and the independent companies may lead to very different transaction terms, such as extremely long-lived contracts, or instances where transfers of unique

intangibles that would not ordinarily be transferred between independent companies are undertaken between the associated enterprises.

5.3.5.16. In some cases material differences may exist in the way transactions are structured by potential comparables and by the tested party, due to the fact that the latter operates with associated enterprises in an MNE group. In such cases it may not be possible to find comparable transactions that have the same transactional structure as the controlled transaction. In these circumstances, adjustments may be needed to eliminate the effects of these differences. For example the margins of independent distributors operating on short term contracts may not be comparable to those of associated enterprises in long term contracts, unless an adjustment is made to account for the short duration of the former.

5.3.5.17. 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 used in the adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.

5.3.5.18. Comparability adjustments are only appropriate for differences that 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.

5.3.5.19. No specific rules or guidelines can be given that may be applicable to every transaction or indicate that comparability adjustments must be made. In each case, the critical factors that have a material impact on the price of the product (if the CUP method is used) or on profit (if the RPM, Cost Plus Method, TNMM or profit split is used) should be identified. Ultimately, this decision depends entirely on the facts and circumstances surrounding the transactions, on the availability of information needed for the analysis and on the accuracy and reliability of any adjustments that may be made.

5.3.5.20. Available information is often not complete enough to enable a review to be made of 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 comparability difficulties should affect the selection of the most appropriate method.

5.3.6. Selection of Transfer Pricing Method

5.3.6.1. The most appropriate transfer pricing method will be selected taking into account the strengths and weaknesses of the method, the appropriateness of the method in the light of the nature of the controlled transaction (based upon a functional analysis), the availability of reliable information (especially on uncontrolled comparables) and the degree of comparability between the controlled and the uncontrolled transactions (including reliability of comparability adjustments needed).

5.3.6.2. Once the taxpayer has identified the transfer 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 may be taken into account to assess the relative accuracy of the identified methods:

- i. The extent to which the comparability factors (characteristics of the property or services, functional analysis, contractual terms, economic circumstances and business strategies) of 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 availability and reliability of financial and other information that is known about the comparable;
- iii. Reliability and accuracy of the comparability adjustments; and
- iv. Reliability of presumptions as well as deficiencies in data and presumptions.

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

5.3.7.1. 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. **See Chapter 6 on methods.**

5.3.8. Documentation of the comparability analysis and monitoring

5.3.8.1. Another important and necessary requirement while performing the comparability analysis is to maintain complete documentation of the analysis, evaluation and selection (and rejection) of comparables along with a substantiation of the adjustments, if any, made. Complying with documentation requirements may be a significant but unavoidable burden for the taxpayer. Chapter [9] deals in detail with all these documentation requirements. **See Chapter 7 on documentation.**

5.4. Issues regarding comparability analysis

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

Some of the common concerns surrounding comparability analysis are described below.

5.4.2. Timing issues

5.4.2.1. There are timing issues in comparability with respect to the time of origin, collection and production of information on comparability factors and comparable uncontrolled transactions that are used in a comparability analysis.

(a) Timing of origin

5.4.2.2. In principle, information relating to the conditions of comparable uncontrolled transactions undertaken or carried out during the same period of time as the controlled transaction (“contemporaneous uncontrolled transactions”) is expected to be the most reliable information to use in a comparability analysis, because it reflects how independent parties have behaved in an economic environment that is the same as the economic environment of the taxpayer’s controlled transaction.

(b) Timing of collection

5.4.2.3. In some cases taxpayers establish transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm’s length principle at the time their intra-group transactions were undertaken, i.e. on an ex ante basis (hereinafter “the arm’s length price-setting” approach), based on information that was reasonably available to them at that point. Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the year of the controlled transaction. In effect, independent parties in comparable circumstances would not base their pricing decision on historical data alone. This ex ante analysis of the arm’s length price may however be limited in practice.

5.4.2.4. In other instances, taxpayers might test the actual outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm’s length principle, i.e. on an ex post basis (hereinafter “the arm’s length outcome-testing” approach). This test typically takes place as part of the process for establishing the tax return at the year-end. An ex post analysis is the most commonly used method to test the arm’s length price of international transactions.

5.4.2.5. The arm’s length price-setting and the arm’s length outcome-testing approaches, as well as combinations of these two approaches, are found among countries that have implemented transfer pricing rules. Country views differ as to whether data on contemporaneous transactions which only become available to the taxpayer and tax administration at the time of filing of the tax return or conducting ex post analysis of transfer pricing is permitted or represents improper use of hindsight.

(c) Valuation highly uncertain at the outset and unpredictable events

5.4.2.6. The question arises as to whether and if so how to take account in the transfer pricing analysis of future events that were unpredictable at the time of the testing of a controlled transaction, in particular where valuation at that time was highly uncertain. The question should be resolved, both by

taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.

5.4.2.7. The main issue is to determine whether the valuation was sufficiently uncertain at the outset that the parties at arm's length would have required a price adjustment mechanism, or whether because the change in value was so fundamental, or other developments arose, this would have led to a renegotiation of the transaction. Where this is the case, the tax administration would be justified in determining the arm's length price for the transaction on the basis of the adjustment clause or renegotiation that would be provided at arm's length in a comparable uncontrolled transaction. In other circumstances, where there is no reason to consider that the valuation was sufficiently uncertain at the outset that the parties would have required a price adjustment clause or would have renegotiated the terms of the agreement, there is no reason for tax administrations to make such an adjustment as it would represent an inappropriate use of hindsight. The mere existence of uncertainty should not require an ex post adjustment without a consideration of what independent enterprises would have done or agreed between them.

(d) Data from years following the year of the transaction

5.4.2.8. Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken to avoid the use of hindsight.

5.4.3. Lack of reliable comparables

5.4.3.1. One of the most frequent problems taxpayers and administrations face with comparability analysis is the lack of reliable comparables with respect to the transaction(s). There may be a number of reasons for this as discussed later.

5.4.3.2. 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 at 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 such 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.

5.4.3.3. Absence of data: In many developing countries, reliable comparable transactions simply may not be available. This 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 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, but even then the administration may not have access to relevant databases and is therefore very reliant on the taxpayer's use of the data.

Another possibility might be to use local comparables from another industry sector which provide sufficient and reliable functional comparability. For instance, if the tested party is a manufacturer in a new industry for which independent comparables are not found, it may be possible to use as comparables manufacturers that have a comparable FUNCTIONAL ANALYSIS but operate in another industry.

5.4.3.4. Use of new technologies, products and services: 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 may be 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.

5.4.3.5. Owing to consolidation and vertical integration, it may be extremely difficult in some industries to find reliable 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 be difficult to find comparable transactions between independent enterprises. In such cases also, it may be possible under certain circumstances to use comparables from other industries, possibly adjusted, in order to address this issue.

5.4.3.6. Non-availability of data: In a number of countries, particularly developing countries, comparable data may not be available in the public domain, or there may not be enough resources or processes in place to collate and make available such data for public consumption. It may be possible under certain circumstances to use foreign comparables, possibly adjusted, to deal with these situations.

5.4.4. “Cherry-picking” of comparables

5.4.4.1. In practice, it is frequently not possible to obtain information on perfect comparables, and it is therefore often necessary to use broad search criteria when identifying third party comparables. 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, extreme results may be rejected as comparables after careful consideration of reasons for such extreme results by the tax authorities as they tend to skew the data. While this could on the one hand be a correct application of the arm’s length principle in certain circumstances, on the other hand the reasons for a loss may be genuine and may not always justify rejecting the loss-making company from the pool of comparables. This may be for instance where the loss is due to a recession year which hit the controlled and uncontrolled transactions in the same way, or where it is due to the independent enterprise being in start-up phase while the associated enterprise is also in a comparable start-up phase, etc.

5.4.4.2. To come to a correct conclusion an unbiased analysis of the facts and circumstances surrounding the transactions has to be carried out. 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. In short, it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result.

5.4.4.3. Well-documented search procedures and comparability criteria make 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.

5.4.5. Losses

5.4.5.1. Analysis of the losses of an enterprise in an MNE group is an important process both in selection of comparables and in making comparability adjustments to the tested party or comparables. This requires careful scrutiny focusing on the type and nature of the losses, period of loss-making and the reasons for such losses. In an MNE group one of the enterprises may 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. Nevertheless, in such cases the question of who will bear the cost of market penetration should be carefully examined. For example the allocation of market penetration expenditure to a limited risk bearing entity is questionable. The expenditure may be more correctly allocated to another company in the MNE group, as limited risk entities typically do not engage in such entrepreneurial activity.

5.4.5.2. There could be number of causes for losses. The most common reasons include:

- The level of the operation;
- The spread of losses with the MNE group i.e. losses may occur only within a single entity in the MNE group or at the overall level of the MNE group;
- Losses could be specific to a single product line or to a multiple product line, or relate to all the products.
- Loss making history within the entity and within the MNE group; and
- Losses on account of natural disasters.

5.4.5.3. Losses can occur for a number of reasons including start-up losses, poor management, deliberate business strategies, excessive financial risk, the business cycle stage or adverse economic circumstances. There are also situations in which specific products result in overall losses for the MNE, but the MNE is itself profitable because it sells other product lines that have positive profits. Losses in particular product lines arise for a variety of reasons, including increased competition, product lines at the beginning or end of their lifecycle or quality issues.

5.4.5.4. Start-up-losses: Depending on the place of business and the line of trade or industry, a new business entity may be unprofitable during the start-up period. The allocation of a quantum of start-up costs and the period of such losses within the MNE group will depend upon the risk of each entity of the MNE group. In general a limited risk entity would not be willing to absorb start-up costs as compared to a risk bearing entity. On the other hand, the allocation of start-up losses to an enterprise operating in a new location as a full-fledged operator with considerable entrepreneurial risk may not be questionable in the initial years as it may be reasonable.

5.4.5.5. Deliberate business strategies: An MNE might undertake deliberate strategies for market penetration to increase market share and the profit potential, resulting in losses in some jurisdictions. However, such business strategies may only justify losses for a reasonable period. Generally, associated parties are expected to act in the same way as independent companies under comparable circumstances and therefore such strategies are acceptable if the business and the economic circumstances require them. However, the allocation of costs of market penetration will depend upon the risk profile of the entities in a MNE group. In uncontrolled circumstances the limited risk bearing entity is not likely to absorb the costs of a market penetration strategy.

5.4.5.6. Losses caused by recession: Whether an entity should share or absorb the losses of a recession will depend upon the facts of each case. However, three important issues arising from a recession that need to be examined are:

Uneven distribution of recession: the impact of a recession may vary from country to country; for example in the year 2009 the recession was experienced more in the developed countries as compared to emerging economies. Accordingly, the location of the associated enterprise is an important factor in deciding the question of sharing the losses of an MNE group. Profitability may also vary across industries. While a particular industry may experience significant losses other industries may not be hit by the recession. This may be a relevant factor if the best available comparables are in a different market or industry.

- **Whether the entity is taking entrepreneurial risk:** the sharing or absorption of the losses due to a recession will depend upon the risk profile of an entity. Sharing of such losses by risk free or limited risk bearing entities would generally be unreasonable.
- **Support payments and associated loss transfer:** this will require a close scrutiny of the inter-company agreement. It is possible that due to a sharp decline in customer demand in a recessionary market, an MNE may sell to customers at a loss in order to protect its market share. At arm's length, the sharing of such losses between the associated enterprises will depend upon the

contractual risk profile of each. It is reasonable to assume that a limited risk or risk free distributor would not share in such loss at arm's length.

5.4.5.7. Losses arising from increased competition: Sometimes a product faces competition because competitors attempt to gain market share by reducing prices or by increasing their marketing expenses, thus creating a loss for the MNE. A transfer pricing analysis should determine which legal entity should bear the cost of the "market competition". Depending upon the comparability analysis, including the functional analysis, a possible solution may be that this cost is borne by a full fledged manufacturer with considerable entrepreneurial risk.

5.4.5.8. Losses arising from product-life cycle issues: The product life cycle has four phrases: start up, growth, maturity and decline. Products at either the beginning or end of their product life cycle may make losses. At the beginning of the life cycle, volumes may be too low to allow efficient manufacturing (realization of economies of scale) which may result in the manufacturer incurring losses. At the other end of the life cycle one of the choices for the MNE is to retain the products to offer a complete product line to customers even though the products may have been replaced by newer technology. However in this case attributing the overall loss to the risk bearing entity may require further scrutiny. Any losses in the growth and maturity stage may involve intensive scrutiny by the tax administration because losses in these phases are most unlikely.

5.4.5.9. Losses arising from quality issues: Poor quality ordinarily arises from design-related or R&D issues, or from manufacturing issues. In the latter case, depending upon the facts and circumstances including the risk profile of the entities in question, the arm's length position can be that the manufacturing affiliate is expected to bear the losses arising from its manufacturing activities. The party responsible for the design or R&D, depending upon the facts and circumstances including the risk profile of the entities in question, may be bearing the losses of that faulty design or R&D.

5.4.6. Evaluation of separate and combined transactions

5.4.6.1. An important aspect of transfer pricing analysis is whether this analysis is required to be carried out with respect to each separate international controlled transaction of a taxpayer or to a bundling of international controlled transactions having a close economic nexus.

5.4.6.2. Ideally the arm's length principle should be applied on a transaction-by-transaction basis. However, there are many cases where separate transactions are so closely linked that such an approach would not lead to an arm's length result. In many cases, transactions are so closely interrelated or continuous that the application of the arm's length principle on a transaction-by-transaction basis becomes cumbersome for all involved. In this case it may be preferable to evaluate the transaction according to the "aggregation" principle.

5.4.6.3. For example, with transactions dealing with intangible property such as the licensing of know-how to associated enterprises together with the supply of vital 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 analyse into separate transactions.

5.4.6.4. Another important aspect of combined transactions is the increasing presence of composite contracts and “package deals” in MNE groups; a composite contract and/or package deal may contain a number of elements including royalties, leases, sales 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, 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.

5.4.6.5. Aggregation issues also arise when looking at uncontrolled comparables. Since third party information is not often available at the transaction level in the absence of internal comparables, 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 basis, applying the relevant methodologies to the facts as they exist in that particular case.

5.4.7. Intentional set-offs

5.4.7.1. 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 each has received should be set-off against the benefit each provided and that only the net gain or loss if any on the transactions needs to be considered for tax assessment.

5.4.7.2. Set-offs can be quite complex; they might involve a series of transactions and not just a single 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 these set-offs the conditions governing the transactions are consistent with the arm’s length principle.

5.4.7.3. The tax authorities may evaluate the transactions separately to determine whether 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, due for example to the asymmetries in the tax treatment of the set-offs under the taxation systems of different countries.

5.4.8. Use of customs valuations

5.4.8.1. The price of goods (and under certain circumstances services – the so-called ‘additional’) in import transactions is the starting point for determination of the assessment of customs duties. A higher price on import reduces the profit and thus the direct tax, while a low price on import lowers the customs duty. Thus, there is an inherent conflict between the revenue implications and perhaps the motivation of the Customs and direct tax authorities. While the direct tax authority may seek to lower the price on import to stop diversion of profit, the customs authority may prefer to determine a higher price on the same imports so as to collect more customs duty. These inherent differences in focus accentuate the challenge tax administrations face in harmonizing the existing transfer pricing and customs valuation methods and principles.

5.4.8.2. The General Agreement on Tariffs and Trade (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 customs 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 according to the WTO Agreement on Customs Valuation⁵. The tax authorities in most of the member countries use the “arm’s length principle” as a standard as set out in OECD Transfer Pricing Guidelines. It is important to note here that both the guidelines set by the WTO and OECD follow the arm’s length principle and both aim at determining a “fair price”, however the approaches of the customs authorities and direct tax authorities are often different and incompatible due to different motivations and aims. There is a need to achieve a convergence of transfer pricing and customs valuation through better coordination and exchange of information between these two authorities.

5.4.8.3. In appropriate circumstances the documented customs valuation may be useful to tax administrations in evaluating the arm’s length character of 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 to ensure that the price of an associated party transaction has not been affected by the special relationship between the parties. Customs authorities in some instances use comparisons between the value attributable to goods imported by associated enterprises and the value for identical or similar goods imported by independent enterprises. There are some similarities between customs valuation and transfer pricing methods, although the former may not be aligned with the latter. Examining customs valuations may provide relevant information and a useful starting point for transfer pricing purposes and may also help in reducing the compliance burden for taxpayers.

5.4.8.4. However when there is no customs duty imposed and goods are valued only for statistical purposes, and for transactions or items which have no rate of duty (e.g. services or transfers of intangibles), relying on customs valuation would not be useful. Furthermore, customs valuation and

⁵ See http://www.wto.org/english/tratop_e/cusval_e/cusval_e.htm.

transfer pricing relate to different areas of taxation: they operate differently and are used for different objectives.

5.4.8.5. 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 direct taxation.

5.4.8.6. Internationally there is a great deal of focus on the interplay between transfer pricing methods on the one hand and customs valuation methods on the other hand. Debates have centred on the feasibility and desirability of the convergence of the valuation and/or administrative systems surrounding the two sets of value determination. Those who favour 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 idea point to the different principles underlying the determination of value, for the levy of customs duty and the levy of tax on profits. The issue is considered in more detail in a later chapter.

5.4.9. Use of secret comparables

5.4.9.1. Concern is often expressed by enterprises over aspects of 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 data 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.

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

5.4.9.3. There is a need to exercise caution against the use of secret comparables unless the tax administration is able, within the limits of its domestic confidentiality requirements, to disclose the data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts. Taxpayers contend that the use of such secret information is against the basic principles of equity, as the taxpayer is required to benchmark its controlled transactions with comparables not available to him, without the opportunity to question comparability or argue that adjustments are needed. Taxpayers contend that it would be unfair if they face the consequences of adjustments made on this basis, such as additions to income, typically coupled with interest, penalties etc. Furthermore, double taxation may not be relieved if secret comparables cannot be disclosed to the Competent Authority of another country.

5.4.10. Recognition of the transaction actually undertaken

5.4.10.1. In other than exceptional cases the arm's length price must be established with regard to the controlled transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer, provided that these are consistent with the arm's length principle. In other than exceptional cases, 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 there are special circumstances. Special circumstances may be present where the economic substance of the transaction differs from its form, or where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

5.4.10.2 In general, restructuring of transactions should not be lightly undertaken as it would create significant uncertainty for taxpayers and may lead to double taxation due to the divergent views of the countries on how the transactions are structured. Whether tax authorities are able to do so depends on their powers under applicable domestic 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.

5.4.11. Overall process complexity

5.4.11.1. Comparability analysis looks simple in theory but in practice it can be a laborious, difficult, time-consuming and, more often than not, expensive exercise. Seeking information, analysing all the data from various sources, documenting the analysis and substantiating adjustments are all steps that cost precious time and money. It is therefore important to put the need for comparability analyses into perspective and to ensure that the compliance burden and costs that should be borne by a taxpayer to identify possible comparables and obtain detailed information thereon are reasonable and proportionate to the complexity of the transaction. It is recognised that the cost of obtaining 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. However, it should be observed that the burden of cost cannot be a reason for the dilution of comparability standards.

5.4.11.2. These resource considerations apply at least as much to many developing countries, and efforts must be made to ensure that their position is not prejudiced by a lack of such resources in ensuring the arm's length pricing of transactions in their jurisdictions.

5.4.11.3. When undertaking comparability analysis there is no requirement for an exhaustive search of all possible relevant sources of information. Taxpayers and tax administrations should exercise judgment to determine whether particular comparables are reliable.

5.5. Conclusion

5.5.1. 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. This is all facilitated by comparability analysis.

5.5.2. A good 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. This will assist in the selection of the most appropriate transfer pricing method in the circumstances of the case. This part of the process is fact-based and requires the taxpayer or tax administration to demonstrate an understanding of how business operates.

5.5.3. In most cases, the application of the selected transfer pricing method will then rely on the identification of uncontrolled comparable transactions. This part of the process may be complicated in particular in countries that have limited access to information on potential comparables. It is worth emphasising that solutions exist to deal with this problem, including the collection of information on internal comparables (i.e. transactions between the taxpayer or its associated enterprise and a third party) where they exist; the collection of public information on third parties (e.g. competitors) that are likely to be involved in uncontrolled transactions comparable to the taxpayer’s controlled transaction or the possible use of databases from other countries.

5.5.4. It is clear that the 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 other 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.

5.5.5. It is essential to put the need for comparability analyses into perspective given the extent of the compliance burden and costs that can arise to a taxpayer or tax administration in identifying possible comparables and obtaining detailed information. Taxpayers and tax administrations should exercise judgment to determine whether particular comparables are reliable.

5.5.6. Furthermore, as noted in the introduction, the lack of comparables for a given controlled transaction does not mean that it is or is not at 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.