

Chapter 7

Comparability Analysis

[Highlighted passages include some – but not all - of the issues under discussion]

Table of Contents

Section #	Topic	Page
1	Rationale for Comparability Analysis	2
2	Comparability Analysis Process	4
3	Comparability Analysis in Operation	4
	➤ Understanding the economically significant characteristics of the industry, taxpayer’s business and controlled transactions	4
	➤ Attributes or comparability factors	6
	➤ Selecting the tested party(ies)	28
	➤ Identifying potentially comparable transactions - internal and external	29
	➤ Comparability adjustments where appropriate	38
	➤ Selection of most appropriate transfer pricing method	43
	➤ Determination of an arm's length price or profit (or range or prices or profits)	43
	➤ Documentation of comparability analysis and monitoring	43
4	Issue regarding comparability Analysis	44
5	Conclusion	55

1. Rationale for Comparability Analysis

1.1. The phrase “comparability analysis” is used to designate two distinct although 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.* transaction between independent enterprises) taking place in comparable circumstances. The latter are often referred to as “comparable uncontrolled transactions” or “comparables”.

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.

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.

1.4. It should be kept in mind that the lack of comparables for a taxpayer’s controlled transaction does not mean that such transaction is, or is not arm’s length or that the arm’s length principle is not applicable to that transaction. In 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 them 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 solely rely on comparables , or to examine the economic substance of the controlled transaction to determine whether its conditions are one 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.

1.5. A controlled and an uncontrolled transactions 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 apple to apple comparison is not possible. . One must therefore use a practical approach in ascertaining the degree of comparability between controlled and uncontrolled transactions. To be comparable does not mean that the two transactions are necessarily identical, but that either none of the differences between them could materially affect the arm's length price or profit or, where such material differences exist, that reasonably accurate adjustments 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.

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:

- 1.6.1. characteristics of the property or service transferred;
- 1.6.2. functions performed by the parties taking into account assets employed and risks assumed, in short termed as "Functional analysis" ("FAR");
- 1.6.3. contractual terms;
- 1.6.4. economic circumstances;
- 1.6.5. business strategies pursued.

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.

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, cost-plus methods and transactional net margin method ("TNMM") generally require a lesser degree of products or services comparability and may be appropriate if functional comparables are available, i.e. where the functions performed, assets used and risks assumed by the parties to the controlled transaction are sufficiently comparable to the functions performed, assets used 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, where the goods distributed may not be exactly the same, but the functional analysis of the two distributors would be comparable. This issue is discussed in the chapter on transfer pricing method.

1.9. This chapter discusses a possible procedure to identify, screen, select and adjust comparables in a manner so as to enable the taxpayer or tax administration to make an

informed choice of the most appropriate transfer pricing method and apply the same correctly to arrive at the appropriate arm's length price or profit (or range of prices or profits).

2. Comparability Analysis Process

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

- 2.1.1. Understanding the economically significant characteristics of the industry, taxpayer's business and controlled transactions
 - 2.1.1.1. Gathering of basic information about the taxpayer
 - 2.1.1.2. Transaction analysis
 - 2.1.1.3. Evaluation of separate and combined transaction
- 2.1.2. Attributes or comparability factors
 - 2.1.2.1. Characteristics of the of the property or service transferred
 - 2.1.2.2. Functional analysis of the controlled transaction under examination
 - 2.1.2.3. Contractual terms of transaction
 - 2.1.2.4. Economic circumstances of transaction
 - 2.1.2.5. Business strategies of parties
- 2.1.3. Selecting the tested party(ies)
- 2.1.4. Identifying potentially comparable transactions - internal and external
- 2.1.5. Comparability adjustments where appropriate
- 2.1.6. Selection of most appropriate transfer pricing method
- 2.1.7. Determination of an arm's length price or profit (or range or prices or profits)
- 2.1.8. Documentation of comparability analysis and monitoring.

3. Comparability Analysis in Operation

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

3.1.1. Gathering of basic information about the taxpayer

3.1.1.1. A precursor to transfer pricing analysis is the collection of background information about the taxpayer and 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 international controlled transactions, details about international controlled transactions (nature of products/ services transferred, value thereof, terms and conditions, etc.).

3.1.1.2. An analysis should be performed of the taxpayer's circumstances including but not limited to the analysis of the industry, competition, economy and regulatory factors

and other elements that may significantly affect the taxpayer and its environment. This analysis is by essence specific to each taxpayer and industry.

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 to understand the taxpayer's circumstances. A study of these documents will provide an idea of the industry to which the enterprise belongs, 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.

3.1.2. *Transaction analysis*

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

3.1.3. *Evaluation of separate and combined transactions*

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 close economic nexus.

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.

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

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, sale 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.

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

3.2. Attributes or comparability factors

3.2.1. *Characteristics of the property or service transferred*

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

3.2.2. *Functional analysis*

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

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.

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 usually will reflect the functions that each enterprise performs, taking into account assets used 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 latter will generally be searched for among uncontrolled transactions that present a similar allocation of functions, assets and risks between the parties.

3.2.2.3. Functional analysis is a process of finding and organizing facts about the transactions in terms of its functions, risks and assets in order to identify how these are divided between the parties involved in the transaction. The functions, risks and assets are analysed to determine the nature of functions performed, degree of risks undertaken and the kind of the assets used 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 used and risks assumed.

3.2.2.4. In conducting functional analysis, an important rule is that the expected return or return earned by the entities involved in a transaction varies directly with the importance of the functions performed, the degree of risks undertaken, and the nature and value of assets deployed. It is therefore extremely important to map the functions performed, assets employed and risks assumed by all the associated enterprises in relation to the controlled transaction under examination.

3.2.2.5. For easy understanding of functional analysis, let's consider an example which can be examined in detail in the subsequent paragraphs below.

[Note: ***Simpler examples to be introduced for illustration purposes,***] For instance:

1. Contract manufacturing of products by ACo, where the technology is owned by an associated enterprise BCo; or
2. Distribution by ACo of products imported from an associated enterprise BCo for sale in ACo's country; or

Export by ACo of natural resources, where the purchaser is an associated enterprise BCo which has done the pre-exploitation development and operates as a trading company.]

ACo is a company incorporated and registered under the laws of Country A. ACo, is the Intelligent Energy Solutions Company and a market leader in the development, production and supply of electronic meters and its components, software, energy monitoring, billing solutions and payment systems. ACo owns technologies related to electronic energy meters. ACo is a part of Entity, the largest metering consortium in the world which shares technology and pool the extensive experience of development and manufacture within a network which covers over thirty countries. ACo has an established marketing network in many developed and developing countries.

BCo is a company incorporated and registered under the laws of Country B, a Wholly Owned Subsidiary company (WOS) of ACo. BCo intends to manufacture 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 customised to cater the needs of domestic users requirements. Such customisations would be carried out by BCo in its own R&D facilities.

BCo entered into an agreement with the ACo to source its core technology, TECHNO A™ - developed and patented by ACo. TECHNO A™, being software driven, allows cost effective product feature enhancements and provides flexibility to utilities to effectively manage electricity revenue and demand side management, thereby limiting or eliminating revenue losses. TECHNO A™ technology was developed in the Country A by ACo. 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 crossborder transaction between BCo and ACo is that of purchase of certain components and technology from ACo. As mentioned earlier that ACo is specialised in dealings in processors and other components of electronic meters and its sub-assemblies. These are critical components of an electronic meter. BCo manufactures energy meters in Country B and uses processors and related component purchased from ACo and post manufacturing BCo sales energy meters to ACo as per its requirements. BCo has its own R&D centre which tries to excel its performance by improving the technologies so as to achieve further efficiencies and dependence on outside sources for technologies is curtailed in future and cost savings could be achieved. Also BCo has penetrated the new product in the territory of country B by incurring huge marketing expenditure to establish its own marketing intangibles, apart from the intangibles of ACo in country A for which technology agreement is in place with A Co. In the following paragraphs, possible process is described on how FAR analysis can be carried out and documented in the given example.

For the purpose of FAR analysis, in the subsequent paragraphs, analysis of the intra-group transactions between ACo & BCo In relation to purchase of components and raw materials can be described by symbols as follows:

Symbol	Comparative risk level standards	Comparative functional level standards
—	No Exposure	No Functions
®	Lowest Exposure	Least Functions
®®	Medium Exposure	Lesser Functions
®®®	Highest Exposure	Highest Functions

(a) Functions performed

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 therefore, are expected to fetch higher returns for the entity performing such functions. Thus, the focus should be not only on identifying the maximum number of functions but also on identification of critical functions performed by the associated enterprises.

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 designing work
- Purchasing and materials management
- Manufacturing, production or assembly work
- Transportation, warehousing and inventory
- Marketing, advertising, publicity and distribution
- *Market intelligence on technological developments and additional features of processors*
- Managerial, legal, accounting and finance, credit and collection, training and personnel management services
- Intra-group services / Support services.

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.

3.2.2.9. Functional analysis can be approached by listing all of the economically significant activities performed in relation to the controlled transaction under examination (such as a list indicated above) and in potentially comparable uncontrolled transactions. In general, a taxpayer should consider preparing this list for both parties to the transaction

(e.g. for the producing and selling/distributing activities) to support the selection of the most appropriate transfer pricing method.

3.2.2.10. Continuing our above example in para 3.2.2.5, following are the functions performed by the respective party.

Functions performed by ACo

Transaction of sale of technology and components of electronic energy meters:

In the context of international transaction of sale of electronic energy meters by BCo on the basis of technological support of ACo, ACo performs following economically significant functions:

- **Market development:** ACo shares its expertise with BCo and assist in developing presentations to be made by BCo before the utilities for development of markets.
- **Product development:** ACo undertakes the product development activities based on the concept developed and offered by it to 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:** ACo undertakes quality control processes in order to ensure that products manufactured by BCo conform to contractual specification, 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 reputation risk and product liability risk.

Transaction of import / purchase of raw material / components by BCo:

In the transactions of purchase of processors and other components by BCo from ACo, the economically significant functions performed by BCo can be summarized as follows:

- *Market development*
- *Market intelligence on technological developments and additional features of processors*
- *Research and development activities*
- *Production planning*
- *Inventory management*
- *Manufacturing*
- *Testing and quality controls*
- *Selling and distribution activities*

- *Post sales activities including replacements.*
- *Technical assistance, wherever required.*

▪

Functions performed by BCo

The functions of BCo are described in the following paragraphs in the context of intra-group transactions for purchase of raw material and components and subsequent sale to domestic utilities are as follows.

- *Market development:* BCo undertakes the market development activities. The market development activities primarily include development of selling concept (i.e. identifying as to how the company can offer a customized solution to a utility having regard to specific issue being faced by the concerned utility). BCo makes sales presentations to utilities and governments and liaison with them for concept selling. Based on acceptance of concept, pilot orders for the meters are procured by the BCo. It also participates in tendering process to procure full commercial orders for the energy meters once pilot runs successfully. BCo also undertakes the activities of advertisement, appointment of distributors, commission agents, sales promotion, market research and marketing strategies. Also BCo has penetrated the new product in the territory of country B by incurring huge marketing expenditure to establish its own marketing intangibles, apart from the intangibles of ACo in country A.
- *Research and development:* BCo has its own R&D centre which tries to excel its performance by improving the technologies so as to achieve further efficiencies and dependence on outside sources for technologies is curtailed in future and cost savings could be achieved.
- *Production Scheduling:* The production by BCo is based on orders obtained from domestic utilities. 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 BCo. Different products may require different tooling. Different contract specification may require different tooling.
- *Assembling:* Assembly involves assembling of components. Assembly operations are mechanical as well as manual. The activity involves mounting of SMT components, manual inspection of placements of the components, computerised shouldering of mounted components, manual inspection of 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. BCo 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. BCo performs testing and ACo undertake quality control measures. Testing activity involves temperature variation testing, testing of manufactured meter against standard meter, etc.*
- *Packaging: BCo packs the products into specially designed containers of various sizes depending on the consignment. The containers are in the form of cartoons and pallet packaging. After packaging, products are delivered to domestic utilities.*
- *Post sales activities: depending on contracts with the customers, BCo undertakes installation and commissioning activities, wherever required under the contracts. It is also responsible for 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 BCo.*
- *Inventory management: BCo is responsible to manage the procurement of raw materials/components and maintain 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

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 management of respective entity which continuously monitor the economic environment surrounding the respective entity, assess their strategic position within the industry and target to achieve their corporate objectives.*
- *Finance, Accounting, Treasury and Legal Function: The management of respective entity is responsible for managing the finance, treasury, legal and accounting functions. Respective entities are also responsible for all local statutory compliance.*

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

Summary of functions performed by ACo and BCo

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

(b) Assets employed

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.

3.2.2.12. The analysis should involve the identification of the type of capital assets used (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 used, such as their age, location, property right protections available, market value, etc.

In case of capital-intensive industries, the employment of a capital asset such as property, plant and equipment, etc. is costly and has to be financed either internally or externally.

However, there can also be cases where 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 comparables, they will be addressed in the comparability analysis. Adjustment might be required to ensure consistency of accounting standards between the controlled transaction and the comparables.

3.2.2.13. It is also essential to know which entity or entities own(s) the intangibles. Note that in some cases, an enterprise which does not own an intangible (“legal owner”) may nevertheless be entitled to share in the return from its exploitation. This issue is further discussed in the Chapter on intangibles.

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

Tangibles owned by BCo

- Land & Building
- Plant & Machinery
- R&D Equipment
- Office Equipment
- Furniture and Fixtures
- Vehicles
- Computers
- Testing Equipment

Intangibles ownership BCo has established a research and development department which tries to excel its performance by improving the technologies so as to achieve further efficiencies and to reduce dependence on outside sources for technologies in future and cost savings could be achieved and also to conduct research and development (R&D) programmes for supporting BCo’s business and to provide technical assistance to its customers. These efforts help increase in production efficiency and product quality.

BCo has established its own marketing intangibles in Country B by incurring huge expenditure on marketing and has penetrated the new product in the territory of country B apart from the intangibles of ACo in country A for which technology agreement is in place with A Co.

ACo is market leader in the development and supply of electronic meters, software, energy monitoring, billing solutions and payment systems. Over the years, it has amassed wealth of proprietary technical knowledge. This includes product specifications, designs, latest manufacturing processes and empirical data on usage of products by the customers in the industry. BCo has entered into a technology license agreement with ACo – for procuring

technology for manufacture of specified products. Thus, BCo uses the process, know-how; operating/quality standards etc. developed/owned by ACo. BCo leverages from these intangibles for continued growth in revenues and profits.

ACo enjoy 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. BCo leverages on ACo's established brand name and reputation for high technology products. ACo's commitment to quality also provides BCo with an edge while selling products in the domestic markets.

Summary of Assets Employed

CATEGORY	LEVEL OF INTENSITY	
	ACo	BCo
Tangible s	⊗⊗	⊗⊗⊗
Intangibles		
- Technological	⊗⊗⊗	⊗⊗
- Brand		
- Legal	⊗⊗⊗	-
- economic	-	⊗⊗⊗
- Marketing	-	⊗⊗⊗

(c) Risks assumed

3.2.2.15. There are three elements in functional analysis: functions, assets and risks. There are two important aspects to risk: how is risk created and which entity bears the risk. Risk is generally created by the ownership or exploitation of assets, or the performance of functions over a time. The next question is which entity bears the risk (see paragraph... below for a discussion of the role of contracts on 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 that the bearing of economically significant risk is related to anticipated reward.

3.2.2.16. In the open market, the greater economically significant risks assumed by an enterprise, the higher the returns that it expects, although the actual return may or may not increase depending on the degree to which such risks are actually realised. Conversely, in case where such risks undertaken by the enterprise in a transaction are minimal, the returns 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.

3.2.2.17. An illustrative list of risks assumed by the parties to the transaction is provided below:

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 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	<ul style="list-style-type: none"> a. Risk of loss associated with capital investment b. Single customer risk c. Risk of losing human capital
6. General business risk	<ul style="list-style-type: none"> a. Risk related to ownership of property b. Risk associated with the exploitation of a business c. Inflation risk
7. Country/regional risk	<ul style="list-style-type: none"> a. Political risk b. Security risk c. Regulatory risk d. Risk related to government policies

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. For instance, not all industries involve the same level of product liability risk.

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.

3.2.2.20. It is not only necessary to identify the risks but also to identify who bears to such risks. The allocation of risks is usually based on contractual terms between the parties. However, contracts between associated enterprises may not specify the allocation of all the risks. Most commonly assigned risks by the contract are controllable risks for example inventory risks, bad debts and foreign exchange risks etc. Market circumstances, price competition, supply of raw material, rise 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.

3.2.2.21. Even where a written contract exists, 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.

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.

3.2.2.23. One relevant, although not determinative factor that can assist in the determination of the allocation of risk by looking at economic substance of the transaction 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 critical component which help to identify party that has greater control over risk are:*

- *Core component with the greater potential to impact profitability of an entity: distribution, marketing, manufacturing, R&D, engineering, procurement, logistic etc.*
- *Key responsibilities: formulation of policy, formulation of plan, budget, fixation of goal and target etc.*
- *Key decision: strategic decisions which have greater potential to impact ability of an entity to generate profit and amount of profits.*
- *Individual responsible for key decision: Senior management like Chief executive officer (CEO), chief financial officer (CFO) and officers below senior management (President and Vice President level) of both parent MNE and subsidiary. Allocation of power to senior management or a level below depends upon location of core function in the country of MNE or subsidiary, their contribution to core component of the various functions, their authority, their responsibility and liabilities in the employment contract of MNE or subsidiary.]*

3.2.2.24. In arm’s length transactions, another factor although not 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 it, 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 can 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.

3.2.2.25. 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. Some contract manufacturers claiming to be “risk free” or “limited risk” have closed down during the financial crisis, demonstrating that they were in fact bearing some risk. On the other hand some risk-bearing associated enterprises have survived the crisis.

3.2.2.26. Continuing the above example in para <3.15>, following are the risks borne by the respective parties.

Risk Category	Exposure to BCo	Exposure to ACo
Market Risk	BCo has significant exposure to this risk because it is responsible for domestic market that it caters to.	ACo does not have any significant exposure to this risk as it is primarily engaged in development of technology hence all market risks with respect to the product including supply, customer service and acceptance are not borne by ACo.
Product liability risk	BCo faces product liability risk as a result of rejection where the products do not conform to order	ACo face this risk arising from the product failure, technology absorption by BCo and consequential

	<p>specification given by domestic utilities. Risks arising from non-conformity with customer specifications or national/international product standards, is borne by BCo. However, this risk is mitigated due to the excellent quality, safety standards and processes deployed by BCo and its own R&D centre.</p>	<p>reputational risk. Further ACo is primarily engaged in product and technology development thus this risk is borne by ACo.</p>
Technology Risk	<p>The manufacturing operations of BCo are non-complex. Further, product technology and know-how have been provided by ACo. Hence BCo does not face any major technology risk.</p>	<p>ACo are exposed to higher technology risk, they being technology owner. Due to market competition and ever-changing technology scenario, they need to continuously upgrade the existing technology and develop new technology to face the market competition. ACo continuously focus on providing products with contemporaneous technology.</p>
Research & Development risk	<p>Since no significant R&D (except for supporting BCo's business and that of providing technical assistance to its customers) is carried out by BCo, it faces no significant risk on this account.</p>	<p>Since ACo serve diverse markets, their engineering and R&D professionals constantly strive to provide innovative solutions that offer competitive advantages for customers worldwide.</p>
Credit Risk	<p>All the major credit risks associated with sales are borne by BCo.</p>	<p>In case of inter-company sale of technology and components, ACo faces minimal risk.</p>
Inventory Risk	<p>BCo is responsible to manage the procurement of</p>	<p>ACo being primarily engaged in product and</p>

	raw materials / components and maintain the requisite stock levels for each product including finished goods. However, this risk is mitigated to the extent of procurement of components from ACo.	technology development and this risk is not borne by ACo.
Foreign Currency Risk	Since BCo imports technology and components from ACo and its sales are restricted to domestic markets, the imports are subjected to appreciation/depreciation of local currency against the foreign currency. Hence BCo is subjected to this risk.	ACo exports technology and components to BCo, hence they are also subjected to appreciation/ depreciation of Rupee against the foreign currency. Hence ACo is also subjected to this risk.

Summary of Risks borne by each party

CATEGORY	LEVEL OF INTENSITY	
	ACo	BCo
Market risk	-	④④④
Product liability risk	-	④④④
Technology risk	④④④	④
Research & Development risk	④④④	④④
Credit risk	-	④④④
Inventory risk	-	④④④
Foreign currency risk	④④	④④

3.2.3. Contractual Terms of transaction

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 arriving at the transfer price. Other than a written contract, the terms of the transactions may be figured out from correspondence and communication between the parties involved. In case the terms of the arrangement between the two parties are not explicitly defined, then the terms have to be deduced from their economic relationship and conduct.

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.

3.2.3.3. Also, explicit contractual terms of a transaction involving members of a MNE may provide evidence as to the form in which the responsibilities, risks and benefits have been assigned among those members. For example, the contractual terms might include the form of consideration charged or paid, sales and purchase volumes, the warranties provided, the rights to revisions and modifications, delivery terms, credit and payment terms etc. 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.

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.

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 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.

3.2.4. *Economic circumstances of the transaction*

3.2.4.1. Economic analysis deals with industry analysis and 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 the taxpayer's country for the same industry
- 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 melt down of the global economy, some of the banks and automobile companies have reported huge losses globally, but significant profits in emerging economies. Where there are such significant differences between the economic circumstances prevailing in different markets, it is not possible to eliminate them by making reliable comparability adjustments and therefore companies from such different markets may not be retained as comparables.

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 industry analysis, where 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, and capital, transportation costs etc.
- Economic conditions of the overall industry and the key value drivers in the industry
- The date and time of transactions
- The existence of a cycle (economic, business, or product cycle)
- And so forth.

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. Markets can be different for numerous

reasons; it is not possible to itemise exhaustively all the market conditions which may influence transfer pricing analysis but some of the key market conditions which influence such an analysis are as follows:

3.2.4.4. Geographical location – In general, uncontrolled comparables ordinarily should be derived from the geographic market in which the controlled taxpayer operates, because there may be significant relevant differences in economic conditions between different markets. If information from the same market is not available, an uncontrolled comparable derived from a different geographical market may be considered if it can be determined that (i) 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.

3.2.4.5. Another aspect of having different geographic markets is the concept of “location savings” which may come into play during transfer pricing analysis. Location savings are the 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 cost
- subsidies
- tax exemptions
- infrastructure costs.

It is quite possible that part of the cost savings may be offset at time by “*dis-savings*” on account of poor infrastructure like quality and reliability of 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.

3.2.4.6. The relocation of a business to a low cost jurisdiction may not only generate location savings, but also give some other location-specific advantages in addition to location savings. This broader concept is known as “location specific advantages” (in short, LSAs). These advantages could be, depending on the circumstances of the case:

- highly specialized skilled manpower and knowledge
- access and proximity to growing local/regional market
- large customer base with increased spending capacity
- better information network
- powerful incentives.

3.2.4.7. Location specific advantages may play a very important role [both] in increasing the profitability of the MNE [and in determining the bargaining positions of the parties]; The incremental profit derived from the exploitation of net location specific

advantages (including location savings) is known as “location rents”. Thus, the term “location savings” represents “cost savings” whereas any potential incremental profit due to location-specific advantages is known as “location rents”. It is quite possible that in a particular case, even though location savings exist, no locational specific advantages are derived i.e., “location rents” may or may not exist depending on the circumstances of the case. There are cases where extra profit are passed on to the customers to lower the price of products, e.g. during a period of intense market competition. Note that circumstances where extra-profits are passed on to customers are varied, and may be permanent or temporary. *[However, at the end of this competition, the MNE may achieve a larger market share with an increased ability to sell products at a higher price and may earn a super profit (location rents) in medium or long run. In these circumstances, the location rents may be considered as a return on the location specific intangibles, if any.]*

Cost savings (e.g. cheaper labour)
- dis-savings (e.g. higher transportation costs)
= net location savings
+/- other location specific conditions (e.g. market conditions)
= net Location Specific Advantages (“LSA”)
=> location rent (i.e. incremental profit), if any

[Where there are reliable comparables for the activity located in a low cost country and the comparables are from the same market, then location savings are not an issue because it can be assumed that the independent comparables themselves have captured an arm’s length share of the location savings (reflecting actual market conditions and bargaining power). This would be the case if the activity is highly competitive.]

Example: An MNE relocates a manufacturing activity from a high cost country A to a low cost country B. Assume that reliable comparables from country B exist for the relocated manufacturing activity, they will provide a reliable measure of the profits that should be made the manufacturing activity in Country B and there will be no need to adjust for location savings or locational specific advantages.]

3.2.4.8. The computation of location savings 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 home country as comparable and comparison of 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. After computation of net location savings, impact of other location specific advantages and disadvantages should be quantified. This may include enhanced capital productivity, efforts in improving efficiency, access to huge market etc. In order to compute net “locational savings” and “location rents” comparison is to be made by adopting a reliable methodology, by establishing what is the relevant base and may involve various adjustments depending upon facts of each case.

3.2.4.9. After the quantification of the location rents, the question remains to whom these location rents belong and how to attribute them to the parent MNE and its overseas subsidiary. Locational savings/location rents will exist only if the following two conditions are met:

- There are quantifiable location rents.
- Local specific conditions or market characteristics prevent locational savings/location rent from being passed on to customers in the form of a decrease in price.

3.2.4.10. If the conditions mentioned are met, location rent is available for attribution. *[The determination of how to share the locational rents between associated enterprises should be made by reference to what independent parties would have agreed in comparable circumstances. This will generally depend on their respective bargaining power which at arm's length would be determined by the competitiveness of the market (availability of substitutes) and the functional analysis of the parties (functions performed, tangible and intangibles used, risks assumed).]*

[The allocation of extra profit from locational savings/location rent depends on relative contribution of function and bargaining power of parties to the transaction.] The basic principle in bargaining theory is that the stronger the position of one party as compared to another party the greater its bargaining power. *[Bargaining power of an entity is an increasing function of its resources which will include*

- *increasing function of its resources;*
- *beneficial or economic of intangible associated to transaction at issue;*
- *competencies and decreasing constraints on its activity;*
- *competitive position; and*
- *to the extent the intangible owner is capable of translating the intellectual property into market power or monopolistic power.]*

It is important to note that bargaining power is not limited to ownership of intangibles but also depends on the extent to which the owner of the intangible is capable of translating it into a stronger competitive position. The stronger the competitive position created by the intangible, the more locational rents would be received by the owner.

[The arm's length allocation of locational savings/locational rents will depend upon relative contribution of function and bargaining position of the MNE and its subsidiary. Since, locational savings/locational rents may arise to the proportion of the functions, market power or secure exclusive access to locational savings advantages by each party and they will share locational savings/locational rents depending upon their contribution in relation to enjoying the market power and secured access to local savings advantages. The application of relative contribution of function and bargaining theory finally leads to profit split method under which profit is allocated in two stages, first basic return on routine functions undertaken by each party to a transaction. The residual profit is then shared between the parties to the transaction in consideration of the relative contribution and bargaining power of each party.]

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, and in the ordinary course they should be taken into account in arriving at an appropriate transfer price in that market. The question becomes whether, in light of these conditions, the transactions between associated enterprises are consistent with comparable uncontrolled transactions between independent enterprises.

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 the 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 payment of interest on external commercial borrowings and the exchange control regulatory requirement authorises 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 enterprises itself borrows in its domestic market at the higher rate than the LIBOR plus say 200 basis point.

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

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, size of the market, and the extent of competition.

3.2.5. ***Business strategies***

3.2.5.1. On a general level business strategies are one of important factors in comparability analysis. However, what constitutes a legitimate business strategy depends on facts and circumstances of each case. Business strategy of an MNE is dependent upon structural characteristics of an industry. Nonetheless, MNEs with different business strategy do exist within the same industry. In fact, business strategy of MNE may vary 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, input 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, ultimate objective of a business strategy of a MNE is to improve market share and overall profitability.

3.2.5.2. On strategic level, market share improving strategy perused by MNEs can be divided in to following three main categories depending upon period of their existence in a market.

- market penetration strategy
- market expansion strategy
- market maintenance strategy

The above referred 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 a MNE is a relative newcomer to a particular market and is seeking to enter and establish its product/services in the new market. A MNE might actively pursue a market expansion strategy to increase market share in highly competitive market. The market maintenance occurs when a MNE has already entered a market and is required to maintain its market share.

3.2.5.3. Market penetration strategy may involve combination of strategy for:

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

3.2.5.4. When a MNE pursues a market maintenance/expansion strategy it might focus on a combination of multiple strategies of:

- attracting users of competitive brands
- pursuing current users to increase usage
- attracting non users of the product category.

All these three market share strategies use two fundamental tactics:

- lowering price on their products on a temporary basis by offering discounts on the product to become extremely competitive in the market
- increasing their marketing and selling expense through increased advertisement, sale promotion activities like offering rebate, free samples, offering extended warranties etc, and increased marketing activities like more salesman and commission agent or distributors.

It is always desirable to isolate costs related to pursuit of above referred to tactics as precisely as possible so that allocation of cost at arm's length principle can be made.

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

- who is the initiator of the strategy?
- whether unusually intense advertising, marketing and sale promotion efforts are taking place since these would provide a signal of market penetration or market share expansion strategies?
- what is nature of relationship between related parties i.e., their responsibilities and risk profile?
- whether it involves intangibles?

This can be illustrated with an example of a limited risk company acting solely as a sale agent with little or no responsibility of market development would generally not bear the cost of a market penetration strategy initiated by its parent company.

3.2.5.6. When a MNE enters in a new market with its product or expand market share of its product in an existing market through its subsidiary, questions of creation of marketing intangible and increase in value of product-related intangibles such as trade mark, trade name etc follow closely behind. Therefore, it is quite important to examine and follow the process of creation of intangible in a market. It is recognised that market research, designing or planning products suitable to market need, advertisement, marketing and sale promotion strategies, after sale services, network of dealers and sale/commission agents may contribute to creation of marketing intangibles. The issue of marketing intangibles creation is also intricately linked to the issue of economic ownership of intangible and compensation for creation of the intangible. In this context, these are two ownership concepts, legal and economic ownership that come into play. In case, where a MNE parent has legal ownership of product trade mark or trade name, its subsidiary may be considered by tax authorities to have economic ownership of associated marketing intangibles that are created based on the subsidiary's contribution to a market share enhancing strategy.

3.3. Selection of the tested party

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 are furnished to the tax administration in order for the latter to be able to verify the selection and application of the transfer pricing method.

3.4. Identification of potentially comparable transactions

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 comparables

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

Advantages:

- i. Internal comparables may have a more direct and closer relationship to the transaction under review than external ones due to one party to the transaction being the same and to the use of identical accounting standards.
- ii. Transaction-specific financial and other information 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 be necessarily in fact 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.

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

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

(b) Third-party comparables / External comparables

3.4.5. The identification and selection of reliable external comparables can be executed in a four step process:

- B.1 Examination of the five comparability factors for the controlled transaction;
- B.2 Development of comparables 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 comparables.

3.4.6. 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

3.4.7. 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 comparables search or “screening” criteria

3.4.8. 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.

3.4.9. 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.

The following broadly defined criteria are illustrative of those typically employed in an initial search process to identify and screen potential comparables. The selection criteria must be

tailored to the characteristics of the controlled transaction under examination. The criteria below must be matched with the specific transfer pricing method chosen:

Geographic, product/service market

3.4.10. 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

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

Business mix

3.4.12. 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

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

Independence

3.4.14. 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

3.4.15. Public or private companies reporting a reasonably standard and detailed accounting of the income statement and balance sheet data provide an objective baseline for subsequent analysis. Restricting the comparables 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 company audited financial statements provide considerably more detail in their

financial statements and in the accompanying notes and management review of operations. Further, audited financial statements are available in a relatively consistent form over time, including retrospective restatement of data wherever necessary, which allows for the use of multi-year statistical analysis that can be applied in prospective pricing decisions.

Relevant period

3.4.16. External comparables must be selected such that the relevant operations and available financial data reflect appropriately the business cycle and general economics of the year or period at issue. Contemporaneous transactions are most likely to reflect similar economic conditions and ensure higher degree of comparability. However there can be exceptions to the above general rule, 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.

Examining multiple year data may be useful in a comparability analysis, but it is not a systematic requirement. 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.

B.3 Approach to identifying potential comparables

3.4.17. In identifying potentially comparable uncontrolled transactions or enterprises, two approaches are possible: the "additive" and the "deductive".

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

3.4.19. 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.

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

3.4.21. Combining the "additive" and "deductive" approaches may lead to being selective or cherry picking and therefore one is cautioned when adopting this approach. If companies are identified from the additive approach which have not been picked up as a result of the

deductive approach, this may suggest that the search strategy applied under the deductive approach is not sufficiently robust and should be reassessed. Therefore, the additive approach could be useful for assessing whether the deductive search strategy is reliable, comprehensive and appropriate given the economic characteristics being considered.

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

B.4 Initial identification and screening of comparables

3.4.23. 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 other information sources than databases, this part of the process may be different.

3.4.24. The process of screening, verification and selection of comparable will largely depend upon availability of database in public domain in the country. It is quite likely that public database may be available in some countries whereas, other countries may not have database in public domain. In such cases, one of the option could be to rely on database of similar or comparable economy with reasonable and reliable adjustment.

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

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

B.5 Secondary screening, verification, and selection

3.4.26. Under this step, the search process focuses on a rigorous review of each transaction or company in the potential independent comparables 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

3.4.27. 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.

3.4.28. 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, regulatory and other government filings, various analytical reports issued by trade and industry associations. The search objective is to identify the most reliable comparables for the controlled transaction under examination according to the specific set of criteria.

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

(a) Electronic data compilations

3.4.30. A general source of information are databases which have been developed by various organizations which compile accounts filed by the companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. Some of these databases compile 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.

3.4.31. The advantage of electronic databases in the comparables search process is that they can provide the ability to sort quickly and retrieve selectively only the potential comparables that meet certain screening criteria. Criteria commonly used for initial screening include industry codes, scale or sales volume, ownership, availability of financial data, and certain financial ratios.

3.4.32. Criteria commonly used for initial screening may include inter alia

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

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

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

3.4.34. 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 that 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 comparables data sources

3.4.35. There are other data sources available to provide more detailed business mix, product lines, geographic market, functional mix, and ownership information on the first-round selection of potential 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 institutions or organisations will maintain databases, research reports, and/or hold files with data on potential comparables. Generally these institutions or organisations would be:
 - Chambers of commerce
 - Trade and professional organisations
 - Embassies, Consulates, Trade missions
 - International organisations (United Nations agencies, Organisation for Economic Cooperation and Development, World Bank, International Monetary Fund)

3.4.36. For easy understanding of screening, let's consider an example which can be examined in detail in the subsequent paragraphs below.

X Co is a 100% subsidiary of the US based software company 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 to the parent company. From this discussion, it is clear that X Co is a captive unit and having only one type of international transactions with the related party, namely, provision of offshore software development services.

The following is the summary of the FAR analysis:

Functions performed

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

Assets deployed

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

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	@@@	-	

Searches for potentially comparable companies were conducted on the publicly available data sources. The steps in the selection process can be summarized as follows:

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 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 equals to US\$ 10 million</u>
<u>Wages to sales</u>	<u>157</u>	<u>To eliminate companies whose wages to sales are less than equals to 25%</u>
<u>Qualitative analysis</u>	<u>8</u>	<u>Companies which fell under the category of “different line of business activity”, “related party transactions”, “loss making” (an average loss over 3 year’s period) and “data unavailable for review” were not considered.</u>

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

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

i. Provide accounting consistency with the tested party

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

ii. Restate, as necessary, for divestiture or acquisitions

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

iii. Segment and eliminate significant non-comparability in product markets or functional operations

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

iv. Adjust for functional differences

3.5.5. 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 limit the usefulness of the comparables in establishing an appropriate arm's-length profit range.

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

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

v. Working capital adjustment

3.5.8. It is very common for the tested party and each of the potential comparables to differ materially in the amount of working capital. Such differences are generally caused by differences in the financing terms of purchase and sale that the company receives from its suppliers and extends to its customers, and by differences in the levels of inventories held by the company. Such differences may generate substantial differences in the capital structure and operating profits of the companies. In order to reduce the effect of differences in terms of purchase and sale and levels of inventories on the profitability measures, adjustments can be made to normalize the receivables, payables, and inventory levels of the comparables and the tested party. The receivables, payables, and inventory balances are adjusted such that the days of each held are equivalent to a normalized number of days. Operating profit is adjusted, in parallel, to reflect the return required in order to hold the increased level of payables, receivables, or inventories. This, however, should be done only if such adjustment can be reasonably made and it improves comparability.

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

3.5.10. Following Illustration is hypothetical. It is only to demonstrate how a working capital adjustment can be calculated.

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

vi. Difference in functional mix

3.5.11. There can be significant differences in the mix of functions performed by the potential comparables 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, performs only first-tier distribution functions, and performs limited manufacturing and assembly functions. To adjust for such differences, the financial results of the comparables may be adjusted to eliminate the margins associated with the functions performed by the comparables but not by the tested party or to include arm's length returns for functions performed by the tested party but not performed by the comparables. Such adjustments can be performed by reference to an arm's length return earned by internal or external comparables; in practice it will often be determined by reference to the returns earned by companies that perform solely those functions.

3.5.12. For example, consider adjustments performed to iron out the material differences in the mix of functions performed by a controlled storage device distributor and a set of independent storage device distribution comparables. Assume that the independent device distributors also perform manufacturing / assembly operations and downstream distribution functions that are not performed by the controlled storage device distributor. In this case, the financial results of the comparables may need to be adjusted to eliminate the margin portions associated with manufacturing / assembly operations and with downstream

distribution functions based upon the profitability earned in uncontrolled comparable storage manufacturing and downstream distribution transactions. On the other hand, assume now that the controlled storage device distributor performs some import functions which are not performed by the independent distributors. The margins of those comparables that did not perform import functions may need to be increased to reflect an arm's length return associated with these functions.

vii. Presence of significant intangibles

3.5.13. Where a significant part of the potential comparables' 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 comparables may need to be rejected.

viii. Risk adjustment

3.5.14. As discussed earlier (in para 3.24 to 3.33) that economically significant risk is related to anticipated reward and it would be expected that this would be the case in a controlled transaction that satisfies the arm's length principle.

3.5.15. Since risk is financial consequence of managing functions and assets over a period of time, correct identification of functions and assets will not only help in identification but also in quantification of risk. In practice both tax payers and tax administration increase the size of set of comparable companies with intention to enhance the reliability of analysis and accordingly the issue of differences in risk between comparables and tested party arises. The degree of comparability between tested party and an uncontrolled taxpayer is impaired when the entities assume different economically significant risk 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.

3.5.16. There is no universally accepted method for risk adjustment. However, in practice MNEs carry out risk adjustment through application of certain methods like but not limited to Capital Asset Pricing Model (CAPM) or Risk Adjusted performance model (RARM). It is worthwhile to accept that most statistical method have its inherent known limitation therefore, risk adjustment must be made carefully and only if a reasonable and accurate adjustment is possible.

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

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

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

3.5.19. In some cases, material differences may exist in the structure of the transactions as performed by a set of potential comparables and by the tested party, due to the very fact that the latter operates with associated enterprises in an MNE group which may behave differently from independent enterprises given its specific commercial organisation. In such cases, it may not be possible to find comparables that have the same transactional structure as the one in the controlled transaction. In these circumstances, the taxpayer may need to adjust the financial results of the comparables to eliminate the effects of these differences.

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

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

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

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

3.5.24. The 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.

x. Comparability Adjustments - Judgment

3.5.25. No specific rules or guidelines can be documented for universal applicability to every transaction that indicates for which comparability difference adjustments must be made. In each case, the critical factors that have material impact on the price of the product (if CUP method is used) or on gross profit (if the RPM or Cost Plus Method or TNMM is used) should be identified. Ultimately, this decision depends entirely on the facts and circumstances surrounding the transactions, on the availability of information needed for the analysis and accuracy and reliability of adjustments.

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

3.6. Selection of Transfer Pricing Method

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

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

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

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

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 5 on methods.**

3.8. Documentation of the comparability analysis and monitoring

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

4. Issues regarding comparability analysis

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

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

4.2. Timing issues

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

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

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.

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). Such test typically takes place as part of the process for establishing the tax return at year-end. An ex post analysis is most commonly used method to test arm's length price of international transactions.

4.2.5. Both 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.

4.2.6. Contemporaneous data which may be available to the taxpayer and tax administration at the time of filing of the tax return or conducting ex post analysis of transfer pricing studies can not be held as use of hindsight.

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

4.2.7. 8.9 The question arises 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.

4.2.8. 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 the change in value was so fundamental a development that it 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 re-negotiation 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

4.2.9. 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.

4.3. Lack of reliable comparables

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 transactions they carry out. There may be a number of reasons for this as discussed later.

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 arm's length or that the arm's length principle is not applicable to that transaction. In some instances where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to determine whether the conditions of the transaction are ones that might be expected to have been agreed between independent parties in similar circumstances – lacking evidence of what independent parties have actually done in similar circumstances.

(a) Due to lack of data

4.3.3. In many developing countries, functionally comparable transactions may simply not be available. It may be due to the fact that a particular sector was only recently opened up or liberalized by the government, or due to the advent of a new sector or industry in the region. The available comparable transactions in such cases are at best inexact and have to be adjusted 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 there, the administration may not have access to relevant databases and is therefore very reliant on the taxpayer's use of the data.

[Note: provide an illustration of country experience using foreign databases.]

Another possibility might be to use local comparables from another industry sector which provides 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 FAR analysis but operate in another industry.

(b) Use of new technologies, products and services

4.3.4. 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. .

(c) Consolidation and Vertical Integration

4.3.5. Due 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.

(d) Non-availability of data

4.3.6. In a number of countries, particularly developing countries, comparables 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 this data for public consumption. It may be possible under certain circumstances to use foreign comparables, possibly adjusted, to deal with these situations.

4.4. “Cherry-picking” of comparables

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 companies may be rejected as comparable 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 the loss may be genuine and may not always justify rejecting the loss-making company from the pool of comparables, 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 also is in a comparable start-up phase, etc.

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.

4.4.3. A well-documented search procedure 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 reasons for rejection of each potential comparable are provided.

4.5. Losses

4.5.1. Analysis of loss of an enterprise in an MNE group is an important process both in selection of comparable and making comparability adjustment to tested party or comparable. This requires careful scrutiny of type and nature of loss, period of loss and reasons for such losses. In an MNE group, one of the enterprises might be suffering a loss, even a recurring one, but the overall group may be extremely profitable. The fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may warrant scrutiny by the tax authorities concerned. Such a situation perhaps indicates that the loss-making enterprise is not getting adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities. However the tax authorities must appreciate the fact that these losses, if short-term, may be the result of a deliberate business strategy for market penetration. Nevertheless, in such cases the question of who will bear the cost of market penetration should carefully be examined. For example allocation of market penetration expenditure to limited risk bearing entity is questionable because it may belong to MNE.

4.5.2. Because the arm’s length response to losses (or to any other transfer pricing challenge) is always tied inextricably to standard operating practices within the MNE’s industry, the important aspect of any transfer pricing study is the industry analysis. A properly conducted industry analysis identifies the profit drivers within the industry, and in this way determines the legal entity that should bear the losses in arm’s length relationship between unassociated parties. The arm’s length answer may vary from industry to industry, and this should be clearly recognized both by the MNE and by the tax authorities during audit of the MNE.

4.5.3. There could be number of causes for loss. The most common reasons includes:

- The level of the operational functionality of the loss entity.
- The spread of losses with the MNE group ie losses may occur only within a single entity in MNE group or at the overall level of MNE group.
- Loss could be specific to a single product line or to a multiple product line or for all the products.
- Loss making history within entity and within MNE group.

4.5.4. To further break down the above macro reasons into micro ones, the reasons for losses include start-up losses, poor management, deliberate business strategies, excessive financial risk, business cycle stage and adverse economic circumstances in the MNE country. 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 products 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, and quality issues.

(a) Start-up-losses

4.5.5. Depending upon place of business and line of trade or industry, a new business entity may be unprofitable during the start-up period. The allocation of quantum of start-up cost and period of such losses within MNE group will depend upon risk matrix of each entities of the MNE group. In general, limited risk entity would not be willing to absorb start up cost as compared to risk bearing entity. For example allocation of start up losses to MNE operating in new location as full fledged operator with considerable entrepreneurial risk may not be questionable in initial year.

(b) Losses caused by poor management in selling affiliate

4.5.6. There may be situation where one of the selling affiliate in which poor management causes operating expenses to exceed a “normal” or “reasonable” amount. In such cases, arm’s length prices produce bottom-line losses in the selling affiliate, and therefore a question may arise that whether those losses remain in the selling affiliate, or should they be transferred to the manufacturing affiliate that supplies them with product? Possible answer to this question is that inefficiencies in a selling affiliate should not be exported to other group companies, because such a allocation would not be arm’s length (i.e., inefficient distributors, operating at arm’s length with unrelated suppliers, are responsible for their own operating expenses). If they are not managed efficiently, they eventually go out of business.

4.5.7. When the parties are associated, however the circumstances are different and generally management will take some number of years to recognized and deal adequately with the inefficiency in the selling affiliate’s management. While the problem is being addressed, losses may continue, and a tax authority may consider these losses unacceptable, on the ground that selling affiliates should not lose money for more than one or two years. If management has dealt effectively with the issue, it can argue that the

inefficiency has been corrected, and adequate documentation will exist to support this position.

(c) *Deliberate business strategies*

4.5.8. A MNE might undertake deliberate strategies for market penetration to increase market share and the profit potential that cause losses in some jurisdiction. However, such business strategies may justify losses for a reasonable period. Generally, associated parties are expected to act as independent companies under comparable circumstances would and therefore such strategies are acceptable if the business and circumstances demands so. However, the allocation of cost of market penetration will depend up risk profile of entities in a MNE group. In uncontrolled circumstances limit risk bearing entity will not like to absorb cost of market penetration strategy which may belong with MNE.

(d) *Losses caused by recession*

4.5.9. Whether an entity should share or absorb the losses of the recession will depend upon facts of the each case. However, three important issues arising from recession needs to be examined are as under:

- **Uneven distribution of recession:** Impact of recession may vary from country to country for example in the year 2009 recession was experienced more amongst the developed countries as compared to emerging economies. Accordingly, the location of associated party is one of the important factor in deciding the question of sharing of the losses amongst a MNE group. Profitability may also vary across industry while particular industry may experience significant losses other industries may not be hit by such recession. This may be a relevant factor in analysis of the losses and its allocation.
- **Whether entity is risk, limited risk or no risk bearing:** The sharing or absorption of the loss due to recession will depend upon risk profile of an entity. Sharing of such losses by no-risk or limited risk entity may be questionable.
- **Support payment Vs loss transfer:** This will require a close scrutiny of inter-company agreement. It is quite possible that due to the sharp decline in customer demand in the market under recession manufacturer has allowed credit to the reseller in order to protect the market share, and in the process the manufacturer had incurred the losses. In this example, sharing of loss between manufacturer and reseller will depend upon the risk profile of reseller located in the market under recession. It is reasonable to assume that a limited risk or no risk distributor may not be willing to share loss unless loss is short term and is so severe that they must participant in the loss to preserve profit opportunity in long run.

(e) Losses arising from increased competition

4.5.10. Sometime a product faces competition because competition attempt to buy market share by reducing prices or by increasing marketing expenses, thus creating a loss for the MNE. A transfer pricing analysis must choose which legal entity should bear the cost of the “market penetration”. Possible solution can be that this cost is borne by the full fledged manufacturing with considerable entrepreneurial risk.

(f) Losses arising from product-line cycle issues

4.5.11. The product like cycle has four phrases: start up, growth, maturity and decline. Products at either the beginning or end of their product life cycle may earn losses. At the beginning of the life cycle, volumes may be too low to allow efficient manufacturing (realization of economies of scale) and manufacturer may be justified in incurring loss. At the other end of the life cycle, products may be retained to offer a complete product line to customers even though the products may have been replaced by newer technology, however in such case overall loss to risk bearing entity may be questionable. Any loss in growth and maturity may involve intensive scrutiny by the tax administration because loss in these phrases is most unlikely.

(g) Losses arising from quality issues

4.5.12. Poor quality ordinarily arises from design-related (R & D) issues or manufacturing issues. In such cases, the arm’s length answer can be that the manufacturing affiliate is expected to bear the cost of losses arising from its activities, be they R & D or manufacturing.

4.6. Evaluation of separate and combined transactions

4.6.1. 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 close economic nexus.

4.6.2. Ideally transfer pricing analysis should be made 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 application of the arm’s length principle on a transaction-by-transaction basis becomes cumbersome for all involved, and thus recourse is often had to evaluating the transaction according to the “aggregation” principle.

4.6.3. For example, with transactions dealing with intangible property such as the licensing of know-how to associate 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 separate out transaction-wise.

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.

4.6.5. Aggregation issues also arise when looking at uncontrolled comparables. This is because, since third party information is not often available at the transaction level in the absence of 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.

4.7. Intentional set-offs

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

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

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

4.8. Use of customs valuations

4.8.1. Price of goods and services in cross border transactions is the starting point for determination of the profit and assessment of custom duties. A higher transfer price

reduces the profit and thus the direct tax, while low transfer price lowers the custom duty. Thus, there is inherent conflict of interest between object and motivation of Custom and direct tax authorities. While the tax authority may seek to lower price on import to stop diversion of profit, the custom authority may prefer to determine a higher price on the same imports so as to collect more custom duty. These inherent differences create barriers for the process of harmonizing the existing transfer pricing and valuation methods and principles.

4.8.2. The General Agreement on Trades and Tariff (GATT, Article VII), now part of the World Trade Organization (WTO) set of agreements, has laid down the general principles for an international system of 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 with the WTO Agreement on Customs Valuation.¹ The tax authorities in most of the countries use “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 approaches of both custom authorities and tax authorities are often different and incompatible due to different motivation and aim. There is need to achieve a convergence of transfer pricing and custom valuation through better coordination and exchange of information between these two authorities.

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 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 values may provide relevant information and a useful starting point for transfer pricing purposes and may also help in reducing the compliance burden for taxpayers.

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

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 taxation.

¹ See http://www.wto.org/english/tratop_e/cusval_e/cusval_e.htm.

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 the convergence point to the higher compliance costs to business and higher enforcement costs to government arising out of two sets of rules existing in the same government. The opponents of this idea point to the different principles underlying the determination of value, for levy of customs duty and levy of tax on profits. The issue is considered in more detail in a later chapter.

4.9. Use of secret comparables

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

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

4.9.3. There is need to exercise caution against the use of secret comparable 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. The taxpayers contend that use of such secret information is against the basic principles of equity, as the taxpayer is required to benchmark its controlled transactions with comparables not available to him, without the opportunity to question comparability or argue that adjustments are needed. If adjustments are made on this basis, the taxpayer faces the consequences of additions to his 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 the other country.

4.10. Recognition of the transaction actually undertaken

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 insofar as 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 such as 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.

4.10.2. In general, restructuring of transactions should not be likely undertaken as it would create significant uncertainty for taxpayers and may lead to double taxation due to the divergent views by the countries on how the transactions are structured. Whether authorities are able to do so will in any case ultimately depend on the provisions of their ability to do so under applicable local law. These issues are relevant to the administration of transfer pricing, but also to developing the underlying legislation at the beginning of a country's transfer pricing "journey" to allow effective administration (and to assist compliance by taxpayers) during the course of that journey.

4.11. Overall process complexity

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

4.11.2. On the other hand 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 lack of such resources in ensuring arm's length pricing of transactions in their jurisdictions.

4.11.3. When undertaking a 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. Conclusion

5.1. Transfer pricing theory meets practice in comparability analysis – the translation of the arm's length principle into the selection of the appropriate transfer pricing method and eventually its application to yield the transfer price are facilitated by comparability analysis.

5.2. A good comparability analysis is an essential step of 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 to 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.

5.3. 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.

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

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

5.6. Furthermore, as noted in introduction, the lack of comparables for a given controlled transaction does not mean that it is not arm's length or that the arm's length principle cannot be applied to it. This is especially important given the growing importance of integrated business models and of transactions involving unique intangibles for which comparables may not be available. The need for a reliable analysis must therefore be balanced with a pragmatic approach and one should not set unrealistic expectations for comparability analyses.