

Agenda Item 6

Working Draft

Chapter 7

Comparability Analysis

[This paper was prepared by Members of the UN Tax Committee's Subcommittee on Practical Transfer Pricing. It is a working draft and should not be cited in any publication.]

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1. Rationale for comparability analysis

1.1. The arm's length principle is generally applied in practice by establishing comparability

distributor, etc.), its market segment, market share,

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

A.4 Selection of the tested party

2.11 When applying a cost plus, resale price or transactional net margin method, it is necessary to choose the party to the transaction for which a financial indicator (mark up on costs, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent

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

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

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

a) Functions performed

2.20 Functions performed are the activities that are carried out by each of the parties to the transaction. In

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

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

c) Risks assumed

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

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

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

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

The of risk undertaken by the taxpayer is not known. 1(2)2.27]TJ/TT31Tf4.655

B.3 Contractual terms of transaction

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

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

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

2.38 It must be noted that contractual differences can influence prices as well as margins of transactions. The party concerned should document the significant contractual differences and evaluate them in the t

B.4 Economic circumstances of the transaction

2.40 Economic analysis deals with industry analysis and circumstances that may be relevant for determining market

2.44 Another aspect of having different geographic markets is the concept of “location savings” which may come into play during transfer pricing analysis. Location savings are the cost savings that a MNE realises as a result of relocation of operations.

b.3. Approach to identifying potential comparables

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

2.66 In the additive approach, a list of third parties is prepared which are believed to be carrying on the potentially comparable transactions. The taxpayer shall then collect as much information as possible on transactions conducted by these third parties to confirm whether they are in effect acceptable comparables, based on the five comparability factors for the controlled transaction. While adopting the additive

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i. Establish comparability benchmarks

a. *GeogrtTTda.*

f. *Financial disclosures*

2.77 Public or private companies reporting a reasonably

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

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

2.88 Criteria commonly used for initial screening may include inter alia

- i. have geographic restrictions with respect to a country or region;
- ii. require a specific industry classification;
- iii. refer to keywords;
- iv. eliminate all those enterprises which may

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

Government sources – many governments and regulatory agencies maintain databases on several industries. Such sources can be located on the agency's Internet websites.

Trade institutions and organisations – often institutions or organisations will maintain databases, research reports, and/or files with data on potential comparables. Generally these institutions or organisations would be:

- Chambers of commerce
- Trade and professional organisations
- Embassies, Consulates, Trade missions
- International organisations (such as United Nations agencies, Organisation for Economic Co operation and

a. Provide accounting consistency with the tested party

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

b. Restate, as necessary, for divestiture or acquisitions

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

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

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

d. Adjust for functional differences

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

2.100 To eliminate the effect of such differences, the financial results of the comparables may need to be adjusted, e.g. by eliminating the margins associated with the functions performed by the comparables.

differences in terms of purchase and sale and levels of inventories on the profitability measures, adjustments can be made to normalize the receivables,

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

ii. *Differences in functional mix*

<decided not to delete>

2.105 Where there are significant differences in the mix of functions performed by the comparables vis à vis the tested party, the feasibility of reasonably accurate adjustments to eliminate the effects of such differences on the comparison should be considered. For example, a controlled distribution company may differ from a set of independent distribution companies in that it performs import and regulatory functions not performed by the independent distributors, performs only first tier distribution functions, and performs limited manufacturing and assembly functions. To adjust for such differences, the financial results of the comparables may need to be adjusted in a reasonably accurate manner to eliminate the margins associated with the functions performed by the comparables but not by the tested party or to include party

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

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

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

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

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

E. Selection of the most appropriate transfer pricing method

2.116 The most appropriate transfer pricing method will be selected taking into account the comparability analysis

3 Issues regarding comparability analysis

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

3.2 Some of the common concerns surrounding comparability analysis are:

a) **Dearth of comparables**

3.3 One of the most frequent problems taxpayers face with comparability analysis is

3.7 Due to consolidation and vertical integration it may be extremely difficult to find good internal or external comparables. An example is the pharmaceutical industry where there exists a high level of vertical integration and consolidation in order to drive up efficiencies. In such

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

3.17 In appropriate circumstances, the documented custom valuation may appropriately be

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

g) Overall process complexity

3.23 Comparability analysis on paper looks simple but in practice it can be a laborious, time

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