

Chapter 5

Comparability Analysis

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5.1 Rationale for Comparability Analysis

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

- x 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.
- x A comparison between the conditions of the controlled transaction and conditions in uncontrolled transactions (i.e. transactions between independent enterprises) taking place in comparable circumstances. The latter are often referred to as “comparable uncontrolled transactions” or “comparables”.

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

5.1.3. A practical difficulty in applying the arm’s length principle is that “comparables”.

5.1.5. A controlled and an uncontrolled transaction are regarded as comparable if the economically relevant characteristics of the transactions being compared and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm's length result. It is recognized that in reality two transactions are seldom completely alike and in this imperfect world perfect comparables are often not available. One must therefore use a practical approach in ascertaining the degree of comparability between controlled and uncontrolled transactions. To be comparable does not mean that the two transactions are necessarily identical, but that either none of the differences between them could materially affect the arm's length price or profit or, where such material differences exist, that reasonably accurate adjustments can be made to eliminate their effect. Thus, in determining a reasonable degree of comparability, adjustments may need to be made to account for certain material differences between the controlled and uncontrolled transactions. These adjustments (which are referred to as "comparability adjustments") are to be made only if the effect of the material differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results.

5.1.6. The aforesaid degree of comparability is typically determined on the basis

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

5.3.1.3. Evaluation of separate and combined transactions

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

5.3.1.3.2. Ideally transfer pricing analysis should be made on a transaction by transaction basis. However, there are cases where separate transactions are so closely linked that such an approach would not lead to a reliable result. Where transactions are so closely interrelated or continuous that application of the arm's length principle on a transaction by transaction basis would become unreliable or cumbersome, transactions are often aggregated for the purposes of the transfer pricing analysis.

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

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

B Co is a company incorporated and registered under the laws of Country B and is a wholly owned subsidiary (WOS) of A Co. B Co intends to manufacture a wide range of electronic

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

The use of these symbols provides a tool to summarize key aspects of a functional analysis, and to qualitatively compare the different enterprises in a multinational group across a number of categories related to functions, assets, and risks, based solely on the facts of a particular case. This tool, commonly referred to as a “tick chart,” is used extensively in Chapter 5 and in the Annexure to Chapter 5. Tick charts, while very useful, are inherently subjective. Accordingly, the same set of facts in the hands of two different analysts may not result in identical tick charts. Caution should be used in giving tick charts quantitative significance. For

- x Marketing, advertising, publicity and distribution;
- x Market intelligence on technological

reputational risk and product liability risk.

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

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

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

Market development;
Market

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

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

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

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

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

Intelligence loading: Intelligence loading refers to the process of loading software and other intelligence features on the manufactured

software Tf 2.1803 0 TD 0 Tc <00

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

Postsales activities depending on the contracts with the customers, B Co undertakes installation and commissioning activities wherever required under the contracts. It is also responsible for the collection of payments from customers. Contractual

Qualitative relative assessment of

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

5.3.2.2.13. It is also essential to know which entity or entities has / have the legal ownership of the intangibles. Note that in some cases an enterprise which does not have legal ownership of an intangible may intangible

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

It is assumed for the purpose of the example that B Co has entered into a technology license agreement with A Co for procuring technology for the manufacture of specified products. Thus

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

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

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

Nature of risks	Particulars
1. Financial risk	<ul style="list-style-type: none"> a. Method of funding b. Fluctuation in interest rates c. Funding of losses d. Foreign exchange risk
2. Product risk	<ul style="list-style-type: none"> a. Design and development of product b. Upgrading / obsolescence of product c. After sales service d. Risks associated with R&D e. Product liability risk f. Intellectual pro[58940TD80010.9(e.)Tj/TT121Tf.75410TD0Tc()Tj/TT6p05Tc(may)T

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

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

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

5.3.2.2.20. It is not only necessary to identify the risks but also to identify who

allocation of risk and whether changes in the pattern of

activities and controls the annual budget for R & D activities of Companies B & C. The CEO, CFO and other senior management personnel of Companies B and C reside in Countries X and Y and are technically and functionally

Risk Category	Exposure of A Co.	Exposure of B Co.
Market Risk	It is assumed that A Co. has the same level of market risk.	It is assumed that B Co. has significant exposure to this risk because it is responsible for the domestic market that it caters to.

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

#

Summary of Risks borne by each party

CATEGORY	LEVEL OF INTENSITY	
	A Co.	B Co.
Market		

modifications, delivery terms, credit and payment terms etc. In addition to an examination of these contractual terms, it will be important to check that the actual conduct of the parties conforms to them.

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

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

5.3.2.4. Economic circumstances of the transaction

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

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

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

5.3.2.4.2. Undertaking

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

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

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

HowA

LSAs can be measured as under:

What is location rent?

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

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

to undertake its production elsewhere at similarly low costs. As another example, it might be that the low cost producer is the first to operate in the low cost jurisdiction and there are no comparable low

5.3.2.5. Business strategies

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

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

5.3.3. Selection of the tested party

5.3.3.1. When applying a cost plus, resale price or transactional net margin method it is necessary to choose the party to the transaction for which a financial indicator (mark up on costs, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the controlled transaction. Attributes of controlled transaction(s) will influence the selection of the tested party (where needed). The tested party normally should be the less complex party to the controlled transaction and should be the party in respect of which the most reliable data for comparability is available. It may be the local or the foreign party. If a taxpayer wishes to select the foreign associated enterprise as the tested party, it must ensure that

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Advantages:

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

A Caution:

- i. Potential internal comparables may not necessarily be the best evidence if there are differences, e.g. in transaction volumes, contractual terms, geographical markets and business strategy, which are material and cannot be eliminated through reliable comparability adjustments.

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

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

(b) Third party comparable / External comparable

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

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

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

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

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

B.1 Examination of the five comparability factors for the controlled transaction

Figure 1: Typical Screening Process

In each of these phases comparables are reviewed in order to determine whether they qualify as comparables for possible inclusion or rejection. The database screening is generally applied with regard to industry code, geographic location, level of market, business mix, scale of operations, independence and financials. The quantitative screening often involves screening the

many developing countries without access to relevant databases and with limited

Relevant period

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

5.3.4.19. Examining multiple year data may be useful in a comparability analysis but it is not a systematic requirement. Multiple year data may be used where they add value and make the transfer pricing analysis more reliable. Circumstances that may warrant consideration of data from multiple years include the effect of business cycles in the taxpayer's industry or the effects of life cycles for a particular product or intangible. However, the existence of any such cycle needs to be aptly demonstrated by the taxpayer.

Diagnostic Ratio:

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

5.3.4.21. The application of diagnostic ratios is based on the assumption that a diagnostic ratio constitutes a value driver of a particular line of business and is a reflection of the comparable functional and risk profile. Most of the countries having transfer pricing rules acknowledge that the application of a net margin method is less sensitive to product and functional similarity than a traditional transaction method. However, Hodriverof/TAcTc/TT5ATf1.35520TD0Tc003>Tj/TTncine'=?O\$LaDCL\$E0transfers

and transparency in the process. In particular, the process should be reproducible by the taxpayer and by the tax administration that wishes to assess it. It is also very important that third party data be refined using qualitative criteria. It would be improper to use financial information relating to the transactions of a large sample of companies that

Information sources for third r

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

- i. geographic restrictions with respect to a country or region;
- ii. a specific industry classification;
- iii. certain keywords;
- iv. elimination of all those enterprises which may have substantial transfer pricing issues themselves and fail an independence screening;
- v. inclusion or exclusion of specific functions such as research and development, production,

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

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

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

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

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

Functions performed⁸

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

Service function	®®	®
After sale function		®®®

Risks assumed

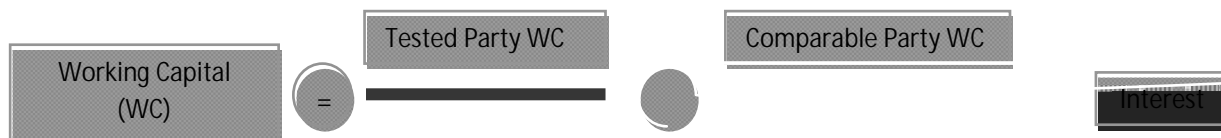
<u>Financial data March 2007 onwards</u>	<u>411</u>	<u>Companies where the latest data is not available have been excluded</u>
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Accounting adjustments:

5.3.5.1. There are various types of difference in accounting

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

Formula –



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

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

Other Adjustments:

5.3.5.7. This category of adjustment is proposed by the taxpayer or tax administrator to adjust for specific economic circumstances that affect the transactions being compared. There can be significant differences in the mix of functions performed by the potential comparables vis à vis the tested party, or in the assets used, risks assumed or capital employed. When such differences exist and are not adjusted, they may affect the reliability of the comparables in establishing an appropriate arm's length profit range.

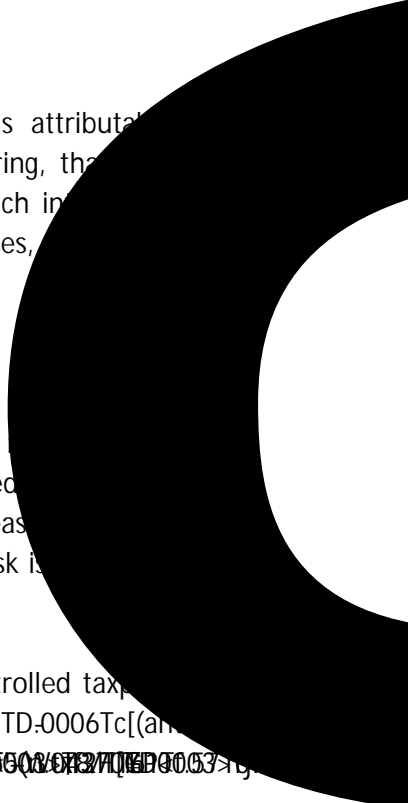
5.3.5.8.

i. Presence of significant intangibles

5.3.5.10. Where a significant part of the potential comparable's profits is attributable to significant, unique intangibles, such as unique product design or unique engineering, that are not present in the tested party, it may not be possible to eliminate the effects of such intangibles from operating profits by performing reliable comparability adjustments. In such cases, the tested party or comparable may need to be rejected.

ii. Risk adjustment

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

5.3.5.12. The degree of comparability between a tested party and an uncontrolled tax-paying party is impaired when the entity is not a party to the transaction. 

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

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

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

5.4.3.4. Use of new technologies, products and services: Similarly when products, property or services are offered by first movers in specific segments there may be a dearth of comparables. These transactions typically involve new technology, cutting edge research,

5.4.4.2. To come to a correct conclusion an unbiased analysis of the facts and circumstances surrounding the transactions has to be carried out. Where one or more of the potential comparables are loss making, further examination would be needed to understand the reasons for such losses and confirm whether the loss making transaction or company is a reliable comparable. The losses might be due to exceptional conditions met by an otherwise comparable third party. Simple or low risk functions in particular are not expected to generate losses for a long period of time. This does not mean however that loss making transactions can never be comparable. In short, it is the facts and circumstances surrounding the company in question that is

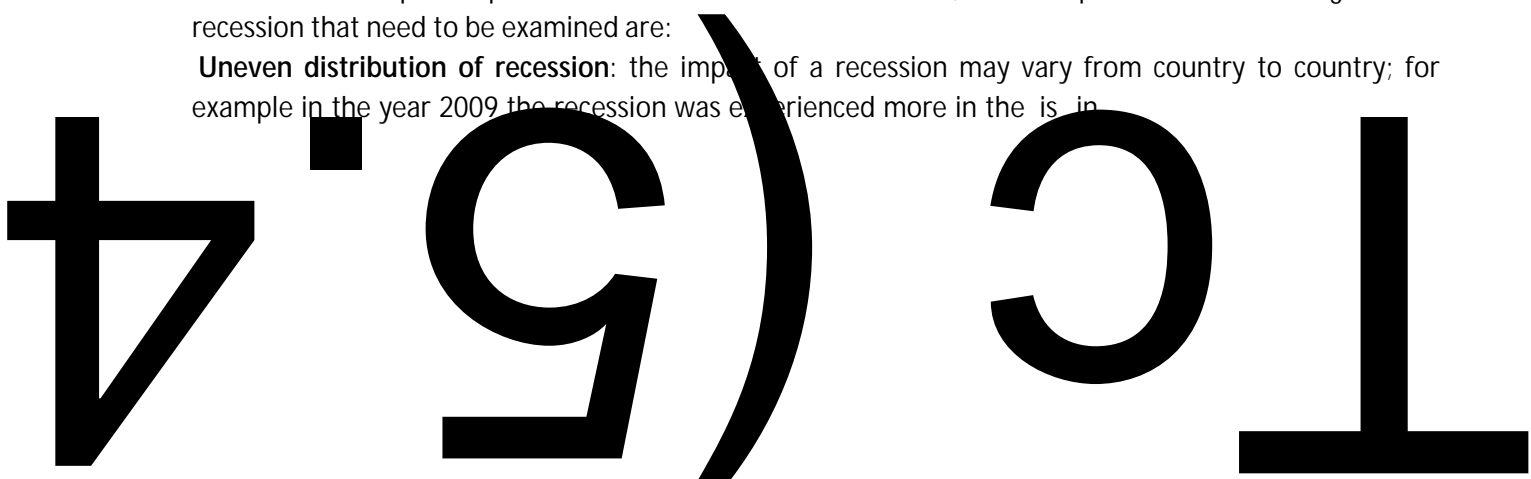
5.4.5.3. Losses can occur for a number of reasons including start up losses, poor management, deliberate business strategies, excessive financial risk, the business cycle stage or adverse economic circumstances. There are also situations in which specific products result in overall losses for the MNE,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

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

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

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

Uneven distribution of recession: the impact of a recession may vary from country to country; for example in the year 2009 the recession was experienced more in the US than in



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

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

5.4.5.8. Losses arising from product life cycle issues: The product life cycle has four phases: start up, growth, maturity and decline. Products at either the beginning or end of their product life cycle may make losses. At the beginning of the life cycle, volumes may be too low to allow efficient manufacturing

5.4.6.3. For example, with transactions dealing

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

5.4.8.5. Even when utilising the customs

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.