B.2. COMPARABILITY ANALYSIS

B.2.1. Rationale for Comparability Analysis

B.2.1.1. The term "comparability analysis" is used to designate two distinct but related analytical steps:

1. An understanding of
   (a) The economically significant characteristics and circumstances of the controlled transaction, i.e. the transaction between associated enterprises, and
   (b) The respective roles and responsibilities of the parties to the controlled transaction. This is generally performed through an examination of five "comparability factors", see further Paragraph B.2.1.6.
2. A comparison between the conditions of the controlled transaction (as established in step 1 immediately above) and those 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".

B.2.1.2. This concept of comparability analysis is used in the selection of the most appropriate transfer pricing method, as well as in applying the selected 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.

B.2. 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 do not 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.

B.2.1.4. It should be kept in mind that the lack of a comparable for a taxpayer's controlled transaction does not imply that the arm's length principle is inapplicable to that transaction. Nor does it imply anything about whether that transaction is or is not in fact at arm's length. In a number of instances it will be possible to use "imperfect" comparables, e.g. comparables from another country with comparable economic conditions or comparables from another industry sector. Such a comparable would possibly need to be adjusted to eliminate or reduce the differences between that transaction and the controlled transaction as discussed in Paragraph B.2.1.5 below. In other instances where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to use approaches do not depend directly on comparables to find an arm's length price[1] (see further Chapter B.3.). It may also be necessary to examine the economic substance of the controlled transaction to determine whether its conditions are such that it might be expected to have

[1] The G20 Development Working Group has commissioned the development of a Toolkit to assist low income countries apply the arm's length principle in cases where access to comparables is limited.

been agreed between independent parties in similar circumstances — in the absence of evidence of what independent parties have actually done in similar circumstances.

B.2.1.5. A controlled and an uncontrolled transaction are regarded as comparable if the economically relevant characteristics of the two transactions 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. It is therefore necessary to use a practical approach to establish the degree of comparability between controlled and uncontrolled transactions. To be comparable does not mean that the two transactions are necessarily identical, but instead means 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.

B.2.1.6. The aforesaid degree of comparability between controlled and uncontrolled transactions 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. An examination of these attributes is therefore necessary to both steps of the comparability analysis. These attributes, which are usually referred to as the five comparability factors, include:

- Characteristics of the property or service transferred;
- Functions performed by the parties taking into account assets employed and risks assumed, in short referred to as the "functional analysis";
- Contractual terms;
- Economic circumstances; and
- Business strategies pursued.

B.2.1.7. 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.

B.2.1.8. The type and attributes of available comparables in a given situation also needs to be considered in determining the most appropriate transfer pricing method. For further information see Chapter B.1, Paragraph B.1.5 and Chapter B.3. In general, closely comparable products or services are required if the Comparable Uncontrolled Price Method is used for arm's length pricing; the Resale Price Method, Cost Plus Method and Transactional Net Margin Method, may also be appropriate where only functional comparables are available, i.e. where the functions performed, assets employed and risks assumed by the parties to the controlled transaction are sufficiently comparable to the functions performed, assets employed and risks assumed by the parties to the uncontrolled transaction so that the comparison makes economic sense. An example would be two comparable distributors of consumer goods of the same industry segment, where the goods distributed may not be

exactly the same, but the functional analyses of the two distributors would be comparable. See further Chapter B.3.

B.2.1.9. Practical guidance is needed for cases without sufficient comparables. There seem to be two distinct problems relating to comparables for developing countries' tax authorities. The first is lack of access to existing sources, such as existing non-local company databases; the second is the lack of reliable local country comparables. For each of these, there are problems associated with both administration (e.g., how the lack of data impedes the reliable and efficient determination of appropriate arm's length results) and problems associated with double tax/dispute avoidance (e.g., how the lack of appropriate data impedes a developing country's ability to reach agreement with other tax authorities, or prevent the developing country from being taken advantage of).

B.2.1.10. The OECD Transfer Pricing Guidelines point out that non-domestic comparables should not be automatically rejected. The Guidelines further recommend that where independent transactions are scarce in certain markets and industries a pragmatic solution needs to be found on a case by case basis.[2] This means that when the data are insufficient, stakeholders can still use imperfect comparables, after necessary adjustments are made, to assess the arm's length price. The validity of such procedures depends heavily on the accuracy of the comparability analysis as a whole.

B.2.1.11. This chapter discusses a possible procedure to identify, screen, select and adjust comparables in a manner that enables the taxpayer or tax administration to make an informed choice of the most appropriate transfer pricing method and apply that method correctly to arrive at the appropriate arm's length price or profit (or range of prices or profits).

B.2.2. Comparability Analysis Process

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

- Understanding the economically significant characteristics of the industry, taxpayer's business and controlled transactions
  - Gathering of basic information about the taxpayer
  - Identifying and accurately delineating the controlled transaction in question
  - Evaluation of separate and/or combined transactions;
- Examination of comparability factors of the controlled transaction
  - Characteristics of the property or service transferred
  - Functional analysis of the controlled transaction under examination
  - Contractual terms of the transaction
  - Economic circumstances of the transaction
  - Business strategies of the parties;
- Selecting the tested party(ies) (if applicable);

[2]OECD, "Transfer Pricing Guidelines for Multinational Enterprises" at Paragraph 3.35 and 3.38.

- Identifying potentially comparable transactions — internal and external;
- Comparability adjustments where appropriate;
- Selection of the most appropriate transfer pricing method;
- Determination of an arm's length price or profit (or range of prices or profits);
- Documentation of comparability analysis and monitoring.

B.2.3. Comparability Analysis in Operation

B.2.3.1. Understanding the Economically Significant Characteristics of the Industry, Business and Controlled Transactions

Gathering of basic information about the taxpayer

B.2.3.1.1. An essential first step to enabling effective transfer pricing analysis is the collection of information about the taxpayer to understand its business operations and activities. This fact-finding process should include identification of associated enterprises involved in the controlled transaction, and gathering information about relevant cross-border controlled transactions in the context of the commercial and financial relations between the enterprises (including the functions performed, assets used (including intangibles, see Chapter B.5.) and risks assumed, by each party, the nature of products/services transferred, the terms and conditions of the transaction, the economic circumstances, etc.).

B.2.3.1.2. An analysis should be performed of the taxpayer's circumstances including but not limited to an analysis of the industry, competition, economy, regulatory factors and other elements that may significantly affect the taxpayer and its environment. This analysis is by nature specific to each taxpayer and industry.

B.2.3.1.3. Information about the taxpayer from its annual report, product brochures, news articles, research reports prepared by independent agencies, management letters and internal reports could act as a good starting point for understanding the taxpayer's circumstances. A study of these documents will provide an idea of the industry to which the enterprise belongs, the nature of its business activities (i.e. manufacturer, wholesaler, distributor, etc), its market segment, market share, market penetration strategies, type of products/services dealt in, etc.

Identify the accurately delineated transaction

B.2.3.1.4. The arm's length price must be established in relation to transactions actually undertaken. Thus, the critical first step in any comparability analysis is to accurately define those transactions by analysing their economically relevant characteristics, as reflected not only in the contracts between the parties, but also their conduct and any other facts. In this regard, the contractual terms will generally be the starting point for the analysis (as clarified or supplemented by the parties' conduct); and to the extent that the conduct or other facts are inconsistent with the written contract, the former should be taken as the best evidence of the transaction(s) actually undertaken.

B.2.3.1.5. Tax authorities should not substitute other transactions in the place of those that have actually happened and should not disregard those transactions actually undertaken other than in

exceptional circumstances. Such circumstances may exist, for example, where the arrangements viewed in their totality are not commercially rational thereby preventing the determination of an arm's length price for each party to the transaction (taking into account their own perspectives and the options realistically available to each of them). This test is a substantive one and looks at the nature of the arrangements entered into: a lack of comparable, independent transactions does not, of itself, indicate that the controlled transaction lacks commercial rationality.

B.2.3.1.6. The test for commercial rationality must be considered from each entity's own perspective, as an arrangement that is commercially rational at group level is not necessarily arm's length from the perspective of each party.

B.2.3.1.7. In addition, an arrangement that is expected to leave the MNE group as a whole worse off on a pre-tax basis than it would be if it had not entered into the arrangement will raise the question whether it is primarily tax driven and it may warrant further examination as to whether it is commercially irrational thereby preventing the determination of an arm's length price for each party to the transaction.

B.2.3.1.8. Where a transaction that was actually undertaken is not commercially rational, any alternative transactions that are substituted for transfer pricing purposes should correspond as closely as possible to the actual facts of the case whilst achieving a commercially rational expected result: i.e. one which would have enabled party the parties to come to a price acceptable to both at the time the arrangement was entered into.

B.2.3.1.9. In general, non-recognition or substitution 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 any substitute transactions are structured. The ability of tax authorities to disregard or substitute transactions will depend on their powers under applicable domestic law, and should be considered in developing domestic transfer pricing legislation and administrative rules. See further Chapters B.8. and C.5.

Evaluation of separate and combined transactions

B.2.3.1.10. An important aspect of transfer pricing analysis is whether this analysis has to be carried out with respect to a taxpayer's individual international controlled transactions or to a group of international controlled transactions having a close economic nexus.

B.2.3.1.11. The transfer pricing analysis should ideally 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 analysis.

B.2.3.1.12. An example can be the case 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, compared to a consideration of each separate activity without recognizing that they are closely interrelated transactions. Similarly, long-term service supply contracts and pricing of closely linked products are difficult to analyse separately.

B.2.3.1.13. Another important aspect of combined transactions is the increasing presence of composite contracts and "package deals" in an MNE group. A composite contract and/or package deal may contain a number of elements including leases, sales and licenses all packaged into one deal. Generally, it will be appropriate to consider the deal in its totality to understand how the various elements relate to each other, but the components of the composite contract 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 composite contract or package deal.

B.2.3.1.14. "Aggregation" issues also arise when looking at potential comparables. Since third party information is not often available at the transaction level, entity level information is frequently used in practice when looking at external comparables (e.g. in the absence of reliable internal comparables; "external comparable" and "internal comparable" are defined in Paragraph B.2.3.4.1.below). It must be noted that any application of the arm's length principle, whether on a transaction-by-transaction basis or on an aggregation basis, needs to be evaluated case by case, applying the most appropriate transfer pricing method to the facts in that particular case.

B.2.3.2. Examination of Comparability Factors of the Controlled Transaction

As has been stated above, the first part of a comparability analysis for transfer pricing purposes involves understanding and defining the controlled transaction to be tested. In addition to the contextual information on the industry and the overall business of the taxpayer, this analysis is typically structured around the five comparability factors: the characteristics of the property or service; contractual terms; functional analysis; economic circumstances and business strategies.

Characteristics of the property or service transferred

B.2.3.2.1. Property, whether tangible or intangible, as well as services, may have differing 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:

- In the case of tangible property: physical features, quality, reliability, availability and the volume of supply;
- In the case of services: nature and extent of such services; and
- In the case of intangible property: form of the transaction (e.g. licensing or sale) and the type and form of property, duration and degree of protection and anticipated benefits from use of the property.

For example, comparability analysis should take into account the differences between trademarks and trade names that aid in commercial exploitation (marketing intangibles) as opposed to patents and know-how (trade intangibles).

Contractual terms of transaction

B.2.3.2.2. The conduct of the contracting parties is generally a result of the terms of the contract between them. The contractual relationship thus warrants careful analysis when computing the

transfer price. Other than a written contract, the terms of the transactions may be found in correspondence and communications between the parties involved. In cases where the terms of the arrangement between the two parties are not explicitly defined, the contractual terms have to be deduced from their economic relationship and conduct.

B.2.3.2.3. An important point to note is that associated enterprises may not hold each other fully to the terms of the contract as they have common overarching interests; this contrasts with 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.

B.2.3.2.4. Also, explicit contractual terms of a transaction involving members of an MNE may provide evidence as to the form in which the responsibilities, risks and benefits have been assigned among those members. For example, the contractual terms might include the form of consideration charged or paid, sales and purchase volumes, the warranties provided, the rights to revisions and modifications, delivery terms, credit and payment terms etc. In addition to an examination of these contractual terms, it will be important to check that the actual conduct of the parties conforms to them.

B.2.3.2.5. 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.

B.2.3.2.6. An example of how contractual terms may affect transfer pricing may be seen in the following example:

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 per cent of the gross revenues of Company B and the remaining 90 per cent 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.

Functional analysis

B.2.3.2.7. Functional analysis typically involves identification of *functions* performed, *assets* employed and *risks* assumed (also called FAR analysis) with respect to the international controlled transactions of an enterprise. Functional analysis seeks to identify and compare the economically significant activities and the responsibilities undertaken by the independent and the associated enterprises. An economically significant activity is one which materially affects the price charged in a transaction and/or the profits earned from that transaction.

B.2.3.2.8. Functional analysis is the cornerstone of any transfer pricing exercise; 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. These will affect the determination of an arm's length remuneration for the transaction since compensation in transactions between two independent enterprises will usually reflect the functions that each enterprise performs, taking into account assets employed and risks assumed. Generally, the more valuable those functions and assets, and the greater the risks, the greater the expected remuneration. Functional analysis is also essential to the identification of potential comparables, as the search for such comparables will generally focus on uncontrolled transactions that present a similar allocation of functions, assets and risks between the parties.

B.2.3.2.9. Functional analysis is a process of finding and organizing facts about the transaction in terms of the functions, risks and assets in order to identify how these are divided between the parties involved in the transaction. The functions, risks and assets are analysed to determine the nature of functions performed, degree of risks undertaken and the nature of the assets employed by each party. This analysis helps to select the tested party/parties where needed (as explained below), the most appropriate transfer pricing method, the comparables, and ultimately to determine whether the profits (or losses) earned by the entities are appropriate to the functions performed, assets employed and risks assumed.

B.2.3.2.10. The functional analysis is important because the expected return of the entities involved in a transaction depends on the importance of the functions performed, the nature and degree of risks assumed and the nature and value of assets employed. Generally, the more valuable the functions performed, assets employed and the greater the risks assumed by a party to a transaction the greater its expected return (or potential loss). It is therefore extremely important to map the functions performed, assets employed and risks assumed by *all* the associated enterprises in relation to the controlled transaction under examination.

B.2.3.2.11. A clearer understanding of functional analysis may be gained from an example which can be examined in detail below. Further, hypothetical examples for illustration purposes concerning the different types of international transactions listed below are given with a view to explaining the chapter in a more practical manner. The situations are:

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

Further hypothetical examples for illustration purposes concerning other types of international transactions are provided at Appendix 1 at the end of this Manual with a view to explaining functional analysis in a more practical manner. The situations covered in such examples are that of a manufacturing entity and of a distributor.

A Co is a company incorporated and registered under the laws of Country A. A Co is in the business of intelligent energy solutions and is a market leader in the development, production and supply of electronic meters and their components, software, energy monitoring, billing solutions and payment systems. Additionally, the company owns technologies related to electronic energy meters. A Co has an established marketing network

in many developing and developed countries. A Co is a part of Entity, one of the largest metering consortia in the world, which shares technology and pools the extensive experience of development and manufacture within a network covering over thirty countries.

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

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

With the above context, the controlled transactions between B Co and A Co are the purchase of certain components and the license of technology from A Co. As noted above, A Co is specialized in dealing with processors and other components of electronic meters and their sub-assemblies. These are critical components of an electronic meter. B Co manufactures energy meters in Country B and uses processors and related components purchased from A Co. B Co then sells energy meters to A Co, in line with its requirements.

B Co has its own R&D centre which tries to improve the technologies so as to achieve further efficiencies. This would mean that dependence on outside sources for technologies would be reduced in the future and cost-savings could be achieved. Also B Co has penetrated the market in the territory of Country B by incurring huge marketing expenditure to establish its own marketing intangibles. These are separate from the intangibles of A Co in Country A for which a technology license agreement is in place between A Co and B Co.

The following paragraphs describe how functional analysis can be carried out and documented in the example just given involving A Co. For these purposes it is necessary to have a qualitative description of the intra-group transactions and circumstances; this can be represented by the following type of table:

Table B.2.1.: Qualitative Assessment of Intra-Group Transactions

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

These symbols are a tool to summarize key aspects of a functional analysis, and to qualitatively compare the different enterprises in a MNE 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 this chapter and in Appendix 1. Tick charts, while very useful, are inherently subjective. Accordingly, the same set of facts in the hands of two different analysts may not

result in identical tick charts. Caution should be used in giving tick charts quantitative significance. For example, three ticks do not reflect three times more value than a single tick. Moreover, all categories in the chart do not have equivalent weight. Accordingly, tick charts should primarily be used as a tool in evaluating qualitative aspects of the analysis, and should not be used mechanically to split profits according to the relative number of ticks.

B.2.3.2.12. **Functions performed** are the activities that are carried out by each of the parties to the transaction. In conducting a functional analysis, economically significant functions are to be considered, as such functions add more value to the transactions and are therefore expected to fetch higher anticipated returns for the entity performing such functions. Thus, the focus should not be on identifying the maximum number of functions but rather on the identification of critical functions performed by the associated enterprises.

B.2.3.2.13. Some of the relevant functions that are generally observed and examined in a transaction are:

- Research and development;
- Product design and engineering;
- Manufacturing, production, process engineering and design work;
- Purchasing, materials management and other procurement activities;
- Manufacturing, production or assembly work;
- Transportation, warehousing and inventory;
- Marketing, advertising, publicity and distribution;
- Market intelligence on technological developments; and
- Intra-group services, for example managerial, legal, accounting and finance, credit and collection, training and personnel management services.

B.2.3.2.14. It should be emphasized that this list is purely indicative; the extent to which each of these functions (or other functions not listed above) is economically significant and contributes to the creation of value depends on the industry and on the taxpayer-specific circumstances. A typical check list is provided in Appendix 1.

B.2.3.2.15. Functional analysis can be approached by evaluating all the economically significant activities performed in relation to the controlled transaction under examination (such as the list indicated above) and in potentially comparable uncontrolled transactions. In general, a taxpayer should prepare this list for both parties to the relevant controlled transaction (e.g. for the producing and selling/distributing activities in this example) to ultimately support the selection of the most appropriate transfer pricing method.

B.2.3.2.16. Continuing the example from Paragraph B.2.3.2.11. the following are the functions performed by the respective parties.

Functions performed by A Co

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

In this example, it is assumed that in the context of the sale of electronic energy meters by B Co on the basis of the technological support of A Co, A Co performs the following economically significant functions:

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

With respect to the import/purchase of raw materials/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:

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

Functions performed by B Co

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

- ***Market development:*** B Co undertakes market development activities. The market development activities primarily include development of the sales concept (i.e. identifying how the company can offer a customized solution to a utility having regard to the specific issues being faced by the utility concerned). B Co makes sales presentations to utilities in both the public and private sectors and conducts further liaison with them. Based on acceptance of the concept, pilot orders for the meters are procured by B Co. It also participates in the tendering process to procure full commercial orders for the energy meters once the pilot runs successfully. B Co also carries out activities in relation to advertisement, appointment of

distributors, commission agents, sales promotion, market research and marketing strategies. Also B Co has developed the market for the new product in the territory of Country B by incurring sizeable marketing expenditure to establish its own marketing intangibles that are separate from the intangibles of A Co in Country A;

- ***Research and development:*** B Co has its own R&D centre which tries to boost its performance by improving the technologies so as to achieve further efficiencies, reducing dependence on outside technologies in future and achieving cost savings.;
- ***Production scheduling:*** The production by B Co is based on orders obtained from domestic utilities. The procurement process for the various raw materials/inputs is based on prudently prepared sales forecasts. The procurement function and the ordering processes are looked after by the "materials department". Factors like lead time, availability, negotiations, etc are taken into consideration while deciding the party from which a particular raw material/input is to be purchased;
- ***Tooling:*** The tooling activities in relation to the products to be produced are undertaken by B Co. Different products may require different tooling. Different contract specifications may require different tooling;
- ***Assembly:*** This involves the assembling of components. Assembly operations are mechanical as well as manual. The activity involves mounting surface-mount technology components, manual inspection of placement of the components, computerized soldering of mounted components, manual inspection of the soldering process, mounting of plasma transformed arc components manually, etc;
- ***Intelligence loading:*** Intelligence loading refers to the process of loading software and other intelligence features on the manufactured meter. B Co undertakes this activity based on the technology and microprocessor specification of the contract;
- ***Testing:*** Testing and quality controls are critical processes in the manufacture and marketing of electronic meters. B Co performs testing and A Co undertakes quality control measures. Testing activity involves temperature variation testing, testing of manufactured meters against standard meters etc;
- ***Packaging and delivery:*** B Co packs the products into specially designed containers of various sizes depending on the consignment. The containers are in the form of cartons and pallet packaging. After packaging, products are delivered to domestic utilities;
- ***Post sales activities:*** Depending on the contracts with the customers, B Co undertakes installation and commissioning activities wherever required under the contracts. It is also responsible for the collection of payments from customers. Contractual and non-contractual product warranties are provided to customers. Any replacement or further activities required pursuant to product performance warranties are also undertaken by B Co;
- ***Inventory management:*** B Co is responsible for managing the procurement of raw materials/components and maintaining the requisite stock levels for the products including finished goods. As raw materials are generally product specific and the finished products are manufactured against the confirmed orders from domestic utilities, no substantial inventory management is involved.

General management functions

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

- ***Corporate strategy determination:*** Generally, all policies within the MNE group are determined by the management of the respective entities which continuously monitor the economic environment surrounding the entity, assess their strategic position within the industry and set targets to achieve their corporate objectives;
- ***Finance, accounting, treasury and legal functions:*** The management of the respective entity is responsible for managing the finance, treasury, legal and accounting functions. Each entity is also responsible for all local statutory compliance;
- ***Human resource management function:*** The HR function of each entity is co-ordinated by its management, which is responsible for recruitment, development and training of the personnel including the pay structure.

Table B.2.2: Qualitative Relative Assessment of Functions Performed
(by A Co and B Co in relation to B Co's Market)

Category	**Level of Intensity**	
	A Co	**B Co**
Market development	®	®®®
Product development	®®®	®®
Manufacturing	-	®®®
Quality control	®®	®®®
Post sales activities	-	®®®
General management functions		
Corporate strategy determination	®	®®®
Finance, accounting, treasury and legal	-	®®®
Human resource management	-	®®®

B.2.3.2.17. **Assets** (tangible as well as intangible) that are used by, or transferred between, the associated enterprises in the course of an international controlled transaction need 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.

B.2.3.2.18. The analysis should involve the identification of the type of capital assets employed (e.g. plant and equipment, intangible assets, financial assets, etc) and their significance to the controlled transaction. For economically significant assets it may be necessary to perform a more detailed analysis of the assets employed, such as their age, location, property right protections available, market value, etc.

B.2.3.2.19. In the case of capital-intensive industries, the employment of a capital asset such as property, plant and equipment, etc is costly and has to be financed either internally or externally.

However, there can also be cases where the entities are involved in activities for which the assets employed may not require such a large capital investment. Depending on the applicable accounting standards, interest expenses are sometimes treated as operating expenses ("above the line") or as financial expenses ("below the line"). Where interest expenses are treated as operating expenses in the accounts of the taxpayer and/or of the comparable, they will be addressed in the comparability analysis. Adjustment might be required to ensure consistency of accounting standards between the controlled transaction and the comparable. Differences in the use of assets can sometimes be eliminated or reduced to a significant extent by making comparability adjustments on account of working capital or capacity utilization.

B.2.3.2.20. Where the transactions involve the use or transfer of economically significant intangibles, the special considerations set out in Chapter B.5 should be borne in mind.

B.2.3.2.21. Continuing the above example, the following are the assets employed by the respective parties:

Tangible assets owned by B Co

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

- Land and buildings;
- Plant and machinery;
- R&D equipment;
- Office equipment;
- Furniture and fixtures;
- Vehicles;
- Computers; and
- Testing equipment.

Intangible asset ownership

It is assumed for the purpose of the example that:

- B Co has established a research and development department which tries to increase the level of its performance by improving technologies so as to achieve further efficiencies. This would also reduce dependence on outside sources of technology in the future and achieve cost savings. The department also conducts R&D programmes to support B Co's business and to provide technical assistance to its customers. These efforts help to increase production efficiency and product quality;
- B Co has established its own marketing intangibles in Country B by incurring significant expenditure on marketing and has penetrated the market for the new product in the territory of Country B. As noted above, these marketing intangibles are separate from the intangibles of A Co in Country A for which a technology agreement is in place with A Co;
- B Co has entered into a technology license agreement with A Co for procuring technology for the manufacture of specified products. Thus B Co uses the process, know-how, operating/quality standards etc developed/owned by A Co. B Co leverages value from these intangibles for continued growth in revenues and profits;

- A Co is the market leader in the development and supply of electronic meters, as well as related software, energy monitoring, billing solutions and payment systems. Over the years the company 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;
- A Co enjoys a reputation for quality products. In the international utility markets, product supplies from international players from developed countries are preferred by the customers and utilities as compared to direct product supplies from suppliers located in developing countries. B Co leverages on A Co's established brand name and reputation for high technology products. A Co's commitment to quality also provides B Co with an edge while selling products in the domestic markets.

Table B.2.3: Summary of Assets Employed

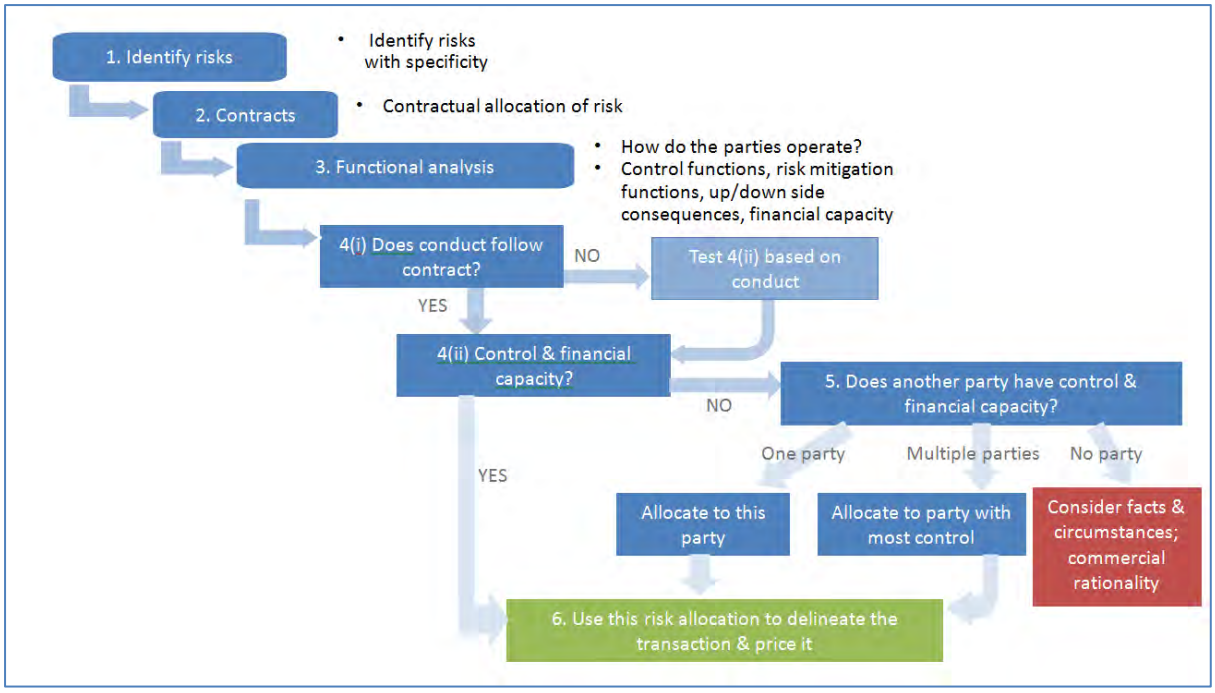
Category	**Level of Intensity**	
	A Co	**B Co**
Tangible assets	✓✓	✓✓✓
Intangible assets	✓✓✓	✓✓
- Technological	✓✓✓	
- Brand	✓	✓
- Legal	✓	✓✓✓

Risks Assumed

B.2.3.2.22. Risk analysis is important in the functional analysis and it should be considered together with the functions and assets. The detailed guidance provided in this section on the analysis of risks as part of a functional analysis covering functions, assets, and risks, should not be interpreted as indicating that risks are more important than functions or assets. The relevance of functions, assets and risks in a specific transaction will need to be determined through a detailed functional analysis.

B.2.3.2.23. Risks are an inherent part of commercial activities. Businesses exist and undertake commercial activities in order to pursue opportunities to make profits. Simply put, risk is the effect of uncertainty on the objectives of the business. As has been noted above, greater risks are associated with higher expected returns – profit-seeking enterprises would only take on risks associated with commercial opportunities if they anticipate a positive return. But such opportunities are inherently uncertain: costs may be higher than anticipated; revenues may be lower; circumstances may change and therefore actual results may be better or worse than those which were expected.

B.2.3.2.24. Since the assumption of economically significant risks will be relevant to the pricing of a transaction, a transfer pricing analysis must first identify such risks, and then determine which entity assumes them. This analysis will start from the contractual terms that exist between the parties, but should also have regard to the conduct of the parties, including the functions they perform and any other relevant facts. Only then can the controlled transaction be properly understood and defined, and from there, appropriately priced. For transfer pricing purposes, the analysis of risk can be broken down into 6 steps, illustrated in the diagram below.



STEP 1 Identification of economically significant risks

B.2.3.2.25. There are many sources and types of risk, the significance of which will vary depending on the nature of the business transaction. The significance of a risk will depend on a combination of its likelihood and its potential impact on the profits (or losses) of the business. For example, the risk associated with the design of new packaging to improve visibility of a product may be relatively small compared to the risk associated with the development of a completely new product line. Changes to a 'flagship' product are likely to carry more risk than changes or variations to a less important product or to one product among many sold by the business, and developments based on novel technologies or wholly new applications are likely to be higher risk than those which build on existing, proven products or technologies.

B.2.3.2.26. An examination of the key functions and commercial context of a transaction will help to identify significant risks. In many cases, an examination of the functions performed, assets used and risks assumed by other associated enterprises in the MNE group contributing to the group's creation of value may help in this process since risks also represent opportunities and businesses will generally allocate resources to manage significant risks.

B.2.3.2.27. An illustrative list of risks that may be assumed by the parties to the transaction is provided below, however the relevance and significance of each individual risk factor listed below will depend on the nature of the transaction.

Table B.2.4.: Illustrative List of Risks Assumed

Nature of risks	**Particulars**

1. Financial risk	a. Method of funding
	b. Fluctuation in interest rates
	c. Funding of losses
	d. Foreign exchange risk
2. Product risk	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
	g. Scheduling risk
	h. Inventory risk
3. Market risk	a. Development of a market including advertisement and product promotion, etc
	b. Fluctuation in demand and prices
	c. Business cycle risk
	d. Volume risk
	e. Service incentive scheme risk
	f. Asset redundancy risk
4. Collection risk	a. Credit risk
	b. Bad debt risk
5. Entrepreneurial risk	a. Risk of loss associated with capital investment
	b. Single customer risk
	c. Risk of losing human capital intangible
6. General business risk	a. Risk related to ownership of property
	b. Risk associated with the exploitation of a business
	c. Inflation risk
7. Country/regional risk	a. Political risk
	b. Security risk
	c. Regulatory risk
	d. Risk related to government policies

B.2.3.2.28. It should be emphasized that this list is purely illustrative, 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 *vis-à-vis* its associated enterprise is very crucial in

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

STEP 2: Contractual assumption of risk

B.2.3.2.29. Once economically significant risks have been identified, the analysis turns to consideration of which party assumes such risks. In this regard, the starting point for the analysis is usually the contractual terms between the parties (STEP 2). 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. However, contracts between associated enterprises may not specify the allocation of all the economically significant risks. Most of the commonly assigned risks in the contract are risks which can be mitigated against, for example inventory risk, bad debts, foreign exchange risk etc. Market circumstances, price competition, the supply of raw materials, rises in wages etc are risks which typically are more difficult to mitigate, and which may not be identified in the contract. Volatility in the global market in the last decade has demonstrated that risks which are difficult to mitigate are often economically more significant than the kinds of contractual risks as mentioned above.

B.2.3.2.30. Moreover, in some cases, written contracts may be inconsistent or may not be followed in practice. For example, in a situation where a contract states that a manufacturer of electronic goods bears warranty risk, but in fact the reseller habitually pays for the cost of customer repairs made under warranty, it is the reseller that is bearing the risk in practice. The determination of the risk assumption between the parties must therefore have regard to the actual conduct of the parties, rather than merely to the legal form of the agreement.

B.2.3.2.31. Even where a comprehensive and consistent contract is in place, an analysis of the conduct of the parties and other facts is critical. In particular, it is important to consider which party or parties control the economically significant risks, and whether a party assigned a risk in fact has the financial capacity to assume it. Both control (see paragraphs B.2.3.2.32. to B.2.3.2.35. immediately below) and financial capacity (see paragraphs B.2.3.2.36. to B.2.3.2.38. below) are necessary for the assumption of risk; but neither is itself sufficient.

STEP 3 Functional analysis in relation to risk

B.2.3.2.32. The next step in the risk analysis process gathers facts on the actual conduct of the parties through a functional analysis. As has been noted above, information relating to the exercise of control over risk and the financial capacity to assume risk are particularly important. This information will then be analysed in the remaining steps.

Control over risk

B.2.3.2.33. While it may be impossible to eliminate or even influence some risks, economically significant risks are central to the success or failure of commercial operations, and thus commercial enterprises generally devote substantial resources to managing significant commercial opportunities and their inherent risks.

B.2.3.2.34. In a transfer pricing analysis, "control" over a risk has a specific meaning. It is:

(i) the capability to make decisions to take on, lay off or decline a risk-bearing opportunity, together with the actual performance of that decision-making function;

(ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and

(iii) either the performance of risk mitigation functions (i.e. taking measures that affect risk outcomes) or, if risk mitigation is outsourced to another party (whether associated or independent), the capability to determine the objectives of the outsourced activities, to decide to hire the provider of those activities, to assess whether the objectives are being adequately met, and where necessary, to decide to adapt or terminate the contract with the provider; together with the actual performance of such assessment and decision-making.

Example

Company X runs a clothing manufacturing facility. It enters into a contract with Company Y to manufacture children's pyjamas on Y's behalf. The design and pattern for the pyjamas are provided by Company Y. Company Y also specifies the sizes and number of pyjamas to be produced, as well as timing of production. Company X is required to manufacture the pyjamas to Y's specifications, including meeting Y's quality standards and using materials approved by Company Y. Company Y undertakes quality control audits to ensure the pyjamas produced by X meet those specifications, and provided that is the case, it guarantees to buy all the pyjamas produced by X as specified under the contract. The contract also states that provided X meets the quality control standards set out by Y, the latter will indemnify it against any warranty or compensation claims which may arise from the sale of the pyjamas.

In this example, the economically significant risks are identified as the inventory risk and warranty / product recall risk. In respect of both of these, Company Y has the capability and actually performs the decision making functions regarding what to produce and when, and it sets and actively monitors the quality control standards and other specifications. Y can therefore be said to control these risks.

B.2.3.2.35. Control over risk involves the process of real decision-making. Decision-makers must be able to understand the risk and the impact the decision could have on the business. They must have access to relevant information. If information or analyses are provided by others, the decision-maker must be able to assess whether the right information has been provided, and whether the analyses being relied upon are adequate. Without the foregoing, the mere formalisation of a decision, for example in the form of the signing of documents or the minutes of a meeting reflecting a decision effectively already made elsewhere, are insufficient.

B.2.3.2.36. The setting of the broad policy framework in which to assess risks is also not enough. For example, the setting by senior management of broad company objectives or a general company 'image' would not mean that such senior management control risks relating to specific marketing strategies. Similarly, a requirement to analyse and report on certain risks in a certain way, or in accordance with a particular framework or template does not constitute control over risk for the purposes of a transfer pricing analysis.

<u>Example 1: Control over Risk by Parent Company</u>

Company A situated in Country Z belongs to an MNE group with operations worldwide through various subsidiaries. Company A is responsible for the overall research programmes of the group. The group has two R&D centres operated by Companies B and C, both subsidiaries of Company A and situated in Countries X and Y respectively. Risks relating to R&D are identified as economically significant (STEP 1).

Company A employs a workforce that includes the Chief Executive Officer, Chief Financial Officer, senior management and technical personnel that provide strategic supervision of the group's R&D activities. Company A claims that it controls and takes all strategic decisions with regard to the core functions of Companies B and C. The contractual arrangements between the companies support this (STEP 2).

STEP 3 Functional analysis: Company A designs and monitors the MNEs overall research programmes, making the decisions regarding which areas of research to pursue, as well as setting the objectives of the research. Company A establishes a reporting and analysis framework against which Companies B and C must provide information on the progress of the research activities. It also provides funds needed for R&D activities and controls the annual budget for R&D activities of Companies B and C. The CEO, CFO and other senior management personnel of Companies B and C reside in Countries X and Y and are technically and functionally competent to take decisions and carry out the R&D activities of Company B and C, under the overall direction of Company A. The technical manpower needed for R&D activity and the assets of companies B and C are located in Countries X and Y.

Company A claims that it controls the risk of the R&D activities of its subsidiaries. On inquiry, it is found that the personnel managing the group's R&D activities in Company A in Country Z are experienced and qualified to make decisions on and to monitor the R&D activities of Companies B and C, and that they in fact do so, based on regular reports provided by B and C on the progress of the research, which it evaluates. In addition, Company A has furnished evidence that it has covered the costs of Companies B and C's R&D activities in all the instances where such activities did not lead to successful outcomes. It was also noted that Companies B and C actually perform R&D functions and take the decisions required for performing the day-to-day functions of R&D.

STEPS 4-6 Analysis and conclusions: In this example, while the actual functions of R&D activities are undertaken in Countries X and Y, Company A contractually assumes the risk related to the ultimate success or otherwise of the R&D activity and has demonstrated that it has the capability to control, and actually controls these risks through its strategic decisions and monitoring activities and through bearing the losses from unsuccessful R&D programmes. Provided Company A has the financial capacity to assume these risks, it will be concluded that Company A assumes the risks associated with the success or failure of the research activity undertaken by Companies B and C. Companies B and C, which perform operational R&D activities and take the decisions necessary to perform these day-to-day functions of R&D and also bear the related operational risk, should be entitled to an appropriate return for these functions and risks.

Company A, which provides the strategic direction and management of the group's R&D activities, funds the group's R&D activities and exercises control over the risk of unsuccessful R&D activity, should be entitled to an appropriate return for its functions and risks. Company A should be entitled to the returns from the intangibles (if any) associated with the R&D, less the appropriate returns to Companies B and C.

Example 2: Control over Risk by Subsidiaries

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

identified as economically significant (STEP 1). Company A, which employs a workforce of ten persons including a CEO, CFO and other senior management, claims that it controls and takes all strategic decisions with regard to the core functions of companies B and C. The contractual arrangements between the companies support this (STEP 2).

STEP 3 Functional analysis: Company A provides the funds needed for R&D activities and controls the annual budget for such activities of Companies B and C. It also provides technical assistance for registration of patents in Countries X, Y and Z. The CEO, CFO and other senior management personnel of Company B and C reside in Countries X and Y and are technically and functionally competent to take decisions and carry out R&D activities of Company B and C. The technical manpower needed for R&D activity and the R&D related assets of Companies B and C are located in Countries X and Y.

Company A claims that it controls the risk of the R&D activities of its subsidiaries. Upon audit it was found that the CEO and CFO and senior management of Company A in Country Z do not have the technical skills and experience to take strategic decisions regarding the direction of the R&D activities, or to monitor those activities. Company A has not furnished any evidence that it takes strategic decisions relating to the R&D programmes of Companies B and C. On the other hand, it was found that the senior management of Companies B and C are taking the important strategic decisions related to the design and direction of the R&D programme and budget, including determining the objectives of the research and evaluating which areas of research to pursue. However, Company A has furnished evidence that the funds were actually transferred to its subsidiaries for R&D activities.

STEPS 4-6 Analysis and conclusions: In this example all the core functions of R&D activities are located in Countries X and Y and the non-core functions of registering patents are located in Country Z. Even though the senior management of company A are located in Country Z they are not capable of taking strategic decisions or controlling and monitoring R&D activities and do not in fact do so. The determination, utilization and control of the budget for carrying out R&D activities and decisions regarding day-to-day performance of R&D activities were carried out by Companies B and C. In view of these facts it cannot be upheld that Company A controls the risk of R&D activities. Company A should be entitled to an appropriate return for the provision of funding and Companies B and C should be entitled to an appropriate return for their functions including the strategic decisions and control over the risk of R&D activities.

Note that in this example, the conclusion would have been the same even if Company A had been a resident of a high tax jurisdiction.

Financial capacity to assume a risk

B.2.3.2.37. Where a risk has materialised it will be a question of fact as to which party bore the consequences. However, since any analysis of risks must take into account temporality (i.e. past risks where outcomes are known are no longer risks at all), it will be relevant to consider whether a party has the financial capacity to assume a risk. Financial capacity to assume risk can be defined as access to funding to take on or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if it materialises. Access to funding takes into account the available assets of the party, as well as the options realistically available to it to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialise. The consideration of whether an entity has the necessary financial capacity should be done on the basis that it is operating as an unrelated party in the same circumstances as the entity. For instance, if an entity has the right to exploit income-generating assets, it is likely to be able to access liquidity against its income stream.

B.2.3.2.38. It should be noted that the financial capacity to assume the risk is not necessarily the financial capacity to bear the full consequences of the risk materializing (e.g. the full loss): the risk-

bearer may have the capacity to protect itself from the consequences of the risk materializing (e.g. by hedging the risk or insuring against the impact of the risk). However, because financial capacity to assume a risk is not by itself sufficient to assume a risk, a high level of capitalization does not necessarily mean that the highly capitalized party assumes the risk.

B.2.3.2.39. It is relevant to mention here that in a multinational enterprise associated entities may work together to exert control over the risks of the entire MNE group. Precise distribution of risk among the associated enterprises may be extremely difficult to achieve. The transfer pricing analysis as to which entity assumes certain risks should therefore be done considering all the facts and circumstances of each case.

STEPS 4-6: Analysing the information gathered to draw conclusions on assumption of risk

B.2.3.2.40. Steps 4 to 6 of the risk analysis framework analyse the information gathered in the earlier steps to determine the assumption of risk for the purposes of the transfer pricing analysis.

B.2.3.2.41. In cases where the contractual assumption of risk is fully supported by the parties' conduct, including an alignment with the exercise of control and financial capacity to assume the risk, the analysis will be straightforward. That is, where a party, which is assigned a risk under a consistent contract (i.e. one that is followed in practice) (STEP 4(i)) also controls that risk and has the relevant financial capacity (STEP 4(ii)), it will be regarded as assuming the risk for the purposes of understanding and defining the transaction and pricing it under a TP analysis (STEP 6). The fact that another party also performs control functions or has financial capacity will not affect the determination of the assumption of risk under the transfer pricing analysis. In some cases, risks may be contractually shared by more than one party.

B.2.3.2.42 In other cases, where the contractual assumption of risk is not aligned with the exercise of control or the financial capacity to assume the risk, the analysis will require an additional step (Step 5). That is, where a party is contractually assigned a risk (or is made to actually bear the costs of the risk when it materialises) (STEP 4(i)) but does not control it, or does not have the relevant financial capacity (STEP 4(ii)), it cannot be regarded as truly assuming the risk. Instead, the party which does exercise control over the risk and has the relevant financial capacity should be allocated the risk (STEP 5). If multiple associated enterprises are identified that both exercise control and have the financial capacity to assume the risk, then the risk should be allocated to the associated enterprise or group of enterprises exercising the most control. This allocation of risk is what should be used to define the transaction and price it for transfer pricing purposes (STEP 6). The other parties performing control activities should be remunerated appropriately, taking into account the importance of the control activities performed.

B.2.3.2.43. In exceptional cases, it may be the case that there is no party that both exercises control and has the financial capacity to assume the risk. Such a scenario would rarely occur between independent enterprises and therefore a thorough analysis should attempt to identify the reasons for this. An assessment of the commercial rationality of such a transaction may be necessary (see Section B.2.3.1.4. to B.2.3.1.9.above).

B.2.3.2.44. The assumption of risk based on the analysis above should be compensated with an appropriate anticipated return. Normally, this means that the party or parties assuming the risk will enjoy the potential upside consequences resulting from the playing out of the risk, for example, the

profits that result from a successful venture risk; but would also bear the potential downside consequences if the risk materialises resulting in greater costs or lower than expected profits. In a proper transfer pricing analysis, associated enterprises should always be appropriately remunerated for their contributions – the functional analysis considers functions and assets and not only risks. For example, parties performing risk mitigation functions on behalf of an entity assuming risk should be adequately compensated at arm's length for those functions. Similarly, where a party is performing control functions, this should be taken into account even if it does not assume the risk relating to those control functions. The form of this compensation will depend on the arrangements between the enterprises and the nature of the contribution: it may be appropriate for such a party to share in the potential upside and downside consequences resulting from the playing out of the underlying risk. Alternatively, the contribution might be compensated in a manner that is not contingent on the underlying risk.

B.2.3.2.45. Continuing the example from Paragraph B.2.3.2.11., it is assumed for the purpose of the example that the following are the risks borne by the respective parties.

Table B.2.5: Risks Exposure

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

	risk is not borne by A Co.	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 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.

Table B.2.6: Summary of Risks Borne by Each Party

Category	**Level of Intensity**	
	A Co	**B Co**
Market risk	**	**
Product liability risk	-	⊛⊛⊛
Technology risk	⊛⊛⊛	⊛
Research and development risk	⊛⊛⊛	⊛⊛
Credit risk	-	⊛⊛⊛
Inventory risk	-	⊛⊛⊛
Foreign currency risk	⊛⊛	⊛⊛

Economic circumstances of the transaction

B.2.3.2.46. Economic analysis deals with industry analysis and the circumstances that may be relevant for determining market comparability. The relevant information on the industry can be broadly classified into following:

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

Care must be exercised while considering global economic trends, as the market trends in the taxpayer's country and in the country of its associated enterprise and/or of the potential comparables (in the case where foreign comparables are used) could be significantly different. For example in the 2008 global financial crisis 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.

B.2.3.2.47. Undertaking a more detailed classification of the above broad headings would yield the following specific factors which may need to be looked at in performing an industry analysis if they are economically significant for the examined controlled transaction:

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

B.2.3.2.48. Market prices for the transfer of the same or similar property may vary across different markets owing to cost differentials and/or differences in purchasing power and habits prevalent in the respective markets which may affect the market price. Markets can be different for numerous reasons; it is not possible to itemize exhaustively all the market conditions which may influence transfer pricing analysis but some of the key market conditions which influence such an analysis are discussed below.

B.2.3.2.49. In general, uncontrolled comparables would first be sought from the **geographic market** in which the controlled taxpayer operates, because there may be significant relevant differences in economic conditions between different markets. If reliable comparables from the same market are 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.

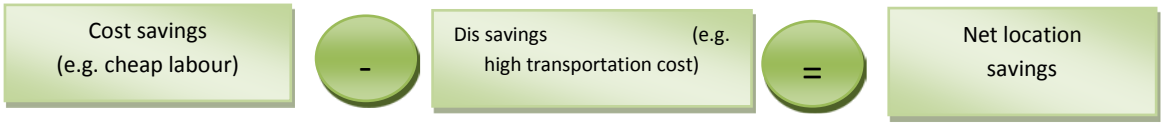
B.2.3.2.50. An example of a potential issue relating to geographic location is that of "location savings", which may come into play during a transfer pricing analysis. Location savings are the net cost savings that an MNE realizes as a result of relocation of operations from a high-cost jurisdiction to a low-cost jurisdiction. Typically, the possibility to derive location savings may vary from one jurisdiction to another, depending for example on the following:

- Labour costs;
- Raw material costs;
- Transportation costs;
- Rent;
- Training costs;

- Subsidies;
- Incentives including tax exemptions; and
- Infrastructure costs.

It is quite possible that part of the cost savings may be offset at times by *"dis-savings"* on account of the poor 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.

B.2.3.2.51. The computation of location savings typically involves the quantification of the net cost savings derived from relocating in a low-cost country, as compared to the relevant high-cost country. In theory, the cost savings computation includes selection of a pre-transfer manufacturing or servicing base in the relevant high-cost country compared to the comparable manufacturing or services cost in the low-cost country, taking into account such things as total labour cost per unit of output (adjustment on account of difference in labour productivity), cost of raw material, costs of land and rent costs; tax benefits etc. The cost savings can be partially offset by higher cost of infrastructure such as less reliable power supplies etc in certain cases.

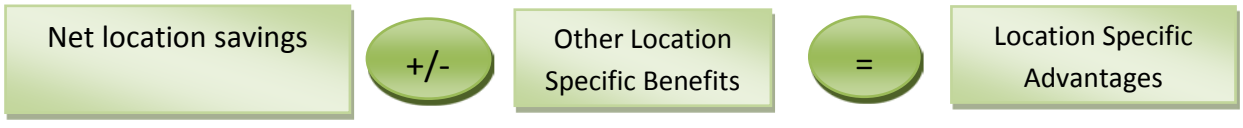


B.2.3.2.52. Location-specific advantages and location savings are defined as a type of benefit related to geographical location. The relocation of a business may in addition to location savings give some other location-specific advantages (LSAs). These LSAs could be, depending on the circumstances of the case:

- Highly specialized skilled manpower and knowledge;
- Proximity to growing local/regional market;
- Large customer base with increased spending capacity;
- Advanced infrastructure (e.g. information/communication networks, distribution system); or
- Market premium.

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

LSAs can be measured as follows:



B.2.3.2.53. 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.

B.2.3.2.54. 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 rent. However, circumstances where extra profits are passed on to customers are varied, and may be permanent or temporary. Where this is temporary, at the end of this period of competition, the MNE may possibly achieve a larger market share in the local market with an increased ability to sell products at a higher price. Alternatively, if an MNE has exclusive access to the LSAs, then the MNE may derive significant location rents associated with the LSAs, as the LSAs reflect a competitive advantage. These location rents may dissipate over time due to competitive pressure, depending on the facts and circumstances of each case.

B.2.3.2.55. As with the determination of whether location rents exist, the arm's length attribution of location rents depends on competitive factors relating to access to the LSAs, and on the realistic alternatives available to the associated enterprises given their respective bargaining power. To the extent that competitors would not have access to the LSAs, the relevant question is why this is so. There are a number of possibilities. For example, the MNE could have production intangibles that allow it to manufacture at a lower cost than competitors. At arm's length, the owner of the intangible would typically be entitled to the rents associated with this cost saving, as it would have a realistic alternative to undertake its production elsewhere at similarly low costs. As another example, it might be that the low-cost producer is the first to operate in the low-cost jurisdiction and there are no comparable low-cost producers in its jurisdiction or other jurisdictions, implying that, for a time at least, it is well-placed to extract a part of the location rents.

B.2.3.2.56. The next question would be the appropriate split consistent with the arm's length principle. As discussed above, the bargaining power of the associated enterprises which reflects the arm's length nature of two independent parties negotiating over their respective shares of savings/rents may be well suited as the key metric for this. This can be used to determine the arm's length surplus (savings/rents) allocations when comparable uncontrolled transactions or benchmarks are not available.

B.2.3.2.57. Government rules and regulations should be treated as conditions of the market in the particular country if they apply in the same way to controlled and uncontrolled transactions. Such

rules would include government interventions in the form of price controls, interest rate controls, exchange controls, subsidies for certain sectors, anti-dumping duties etc, and 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.

B.2.3.2.58. An example of where government rules affect the market is that of certain pharmaceutical formulations, which may be subject to price regulation in a particular country. Another example is Export Oriented Units which may be subject to beneficial provisions under the taxation laws of a country; ideally, companies that enjoy similar privileges should be used as 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 denominated in the same currency, certain countries have restrictions on the payment of interest on external commercial borrowings and the exchange control regulatory requirements authorize the borrower to pay interest at LIBOR plus say 200 basis points. The country of the lender may however not agree to use this as a basis for benchmarking the transaction when the lending enterprise itself borrows in its domestic market at a higher rate.

B.2.3.2.59. The market level of the company is another key factor; for example, the price at the wholesale and retail levels would generally differ.

B.2.3.2.60. Other market conditions — some other market conditions which may influence the transfer price include costs of production (including costs of land, labour and capital), availability of substitutes (both goods and services), level of demand/supply, transport costs, the size of the market and the extent of competition.

Business strategies

B.2.3.2.61. On a general level business strategies are one of the important factors in a comparability analysis. However, the examination of the legitimate business strategy of an MNE will depend on the facts and circumstances of each case. The business strategy of an MNE is dependent upon the structural characteristics of an industry. Nonetheless, MNEs with different business strategies do exist within the same industry. In fact, the business strategy of MNEs may differ due to their different global integration — local responsiveness pressure, different corporate histories, internal efficiencies and competitive advantages. Business strategies would take into account many aspects of an enterprise such as innovation and new product development; degree of diversification, risk aversion, assessment of political changes; impact of existing and planned labour laws, duration of arrangements and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions of the enterprises. However, the ultimate objective of a business strategy of an MNE is to improve its market share and/or overall profitability.

B.2.3.2.62. On a strategic level market share improvement strategies considered by MNEs can be divided into the following three main categories depending on the period of their existence in a market:

- Market penetration strategy;

- Market expansion strategy; or
- Market maintenance strategy.

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

B.2.3.2.63. A market penetration strategy may involve a combination of strategies for:

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

B.2.3.2.64. When an MNE pursues a market maintenance/expansion strategy it may focus on combining multiple strategies of:

- Attracting users of competitive brands;
- Pursuing current users to increase usage; and
- Attracting non-users of the product category.

All these three market share strategies use two fundamental tactics:

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

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

B.2.3.2.65. Market penetration, market expansion and market maintenance strategies are legitimate business strategies that may involve substantial costs, sometimes resulting in significant losses. Accordingly, there is strong implicit recognition that market share strategies cannot be pursued indefinitely by a taxpayer and there has to be some definite time frame in the foreseeable future when these strategies might yield profits. The allocation of the costs of these strategies between an MNE and its subsidiaries is an important issue in transfer pricing and will depend on the facts and circumstances of each case. It is important to examine the following factors in order to address this issue of cost allocation between parties to the transactions:

- Which entity is the initiator of the strategy;
- Which entity is the intended beneficiary of the strategy;
- Whether unusually intense advertising, marketing and sales promotion efforts are taking place since these would provide a signal of market penetration or market share expansion strategies;

- The nature of the relationship between the related parties, i.e. their responsibilities and risk profile;
- Whether the strategy involves intangibles; and
- Which party is the legal and economic owner of such intangibles.

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

B.2.3.2.66. When an MNE enters a new market with its product or expands market share of its product in an existing market through its subsidiary, questions of the creation of marketing intangibles and increases in the value of product-related intangibles such as trademarks, trade names etc follow closely behind. Therefore, it is important to examine and follow the process of creation of intangibles in a market, as well as the legal ownership of such intangibles and the right to share in the return from such intangibles (the notion which some countries refer to as "economic ownership"). It is recognized 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.

B.2.3.3. Selection of the Tested Party

B.2.3.3.1. When applying the Cost Plus Method, Resale Price Method or Transactional Net Margin Method (see further Chapter B.3.) it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the controlled transaction. Attributes of controlled transaction(s) will influence the selection of the tested party (where needed). The tested party normally should be the less complex party to the controlled transaction and should be the party in respect of which the most reliable data for comparability is available. It may be the local or the foreign party. If a taxpayer wishes to select the foreign associated enterprise as the tested party, it must ensure that the necessary relevant information about it and sufficient data on comparables is furnished to the tax administration and vice versa in order for the latter to be able to verify the selection and application of the transfer pricing method.

B.2.3.4. Identification of Potentially Comparable Transactions or Companies

B.2.3.4.1. Comparable uncontrolled transactions ("comparables") are of two types:

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

Internal comparables

B.2.3.4.2. Even though internal comparables may possibly display a higher degree of comparability there is a need to subject internal comparables to as rigorous a scrutiny as external ones regarding

comparability factors, and to make comparability adjustments when necessary. Use of internal comparables may have advantages but also requires caution as mentioned below; accordingly, this will require careful consideration of the facts and circumstances of each case.

B.2.3.4.3. The advantages of internal comparables are:

- 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;
- Transaction-specific financial and other information is more likely to be available;
- Comparability analysis involving internal comparables may be less expensive for the taxpayer as no public database search is required.

B.2.3.4.4. The potential disadvantage of internal comparables is that they 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.

B.2.3.4.5. Internal comparables, where available and reliable, may allow the taxpayer to consider the use of the Comparable Uncontrolled Price Method because it is the most direct method. Internal comparables may also be used with the other recognized transfer pricing methods.

B.2.3.4.6. However reliable, internal comparables may not exist to cover the scope of the controlled transactions under consideration. Thus, the taxpayer often needs to examine external sources of potential comparable transactions among third parties.

Third-party comparable/external comparable

B.2.3.4.7. 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.

B.2.3.4.8. 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:

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

B.2.3.4.9. An illustration of how such a process can be performed follows; it is applicable especially in cases where external comparables are extracted from a database.

Examination of the five comparability factors

B.2.3.4.10. Examination of the five comparability factors for the controlled transaction 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.

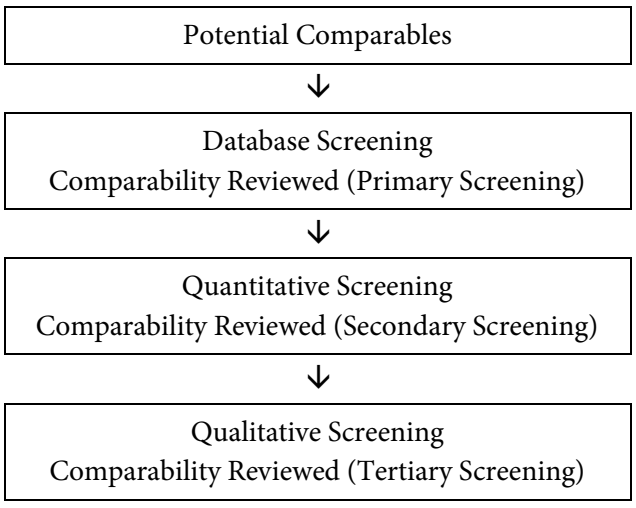
Development of comparable search or "screening" criteria

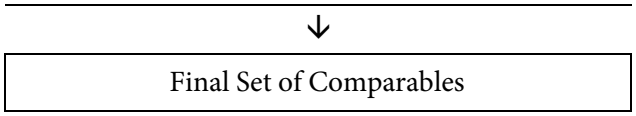
B.2.3.4.11. Comparable search or "screening" criteria are developed based upon the results of the above-mentioned examination of the five comparability factors in relation to the controlled transaction. These criteria must be defined so as to identify those external uncontrolled transactions that satisfy comparability *vis-à-vis* the controlled transaction and the tested party. 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.

B.2.3.4.12. A typical process of comparable searching may be divided into three screening phases, namely (i) database screening (primary screening), (ii) quantitative screening (secondary screening) and (iii) qualitative screening (tertiary screening).

Potential comparables are reviewed in each of these phases to determine whether they qualify as comparables. The database screening is generally applied with regard to industry code, geographic location, level of market, business mix, scale of operations, independence and financials. The quantitative screening often involves screening the financial information relating to the potential comparables for the relevant period to determine whether they have comparable financial information or report sufficient operating profit data. However, qualitative screening is mostly used by applying various financial ratios (referred to as diagnostic ratios) to the remaining potential set of comparables. The qualitative screening is generally performed by diagnostic ratio to reject or accept comparables based on the qualitative information available. After the qualitative screening has been performed the final set of comparables remains. The selection criteria must be tailored to the characteristics of the controlled transaction under examination. The criteria below must be matched with the specific transfer pricing method chosen:

Figure B.2.1: Typical Screening Process





B.2.3.4.13. With regard to geographic location and the product/service market, 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 analyze and adjust the foreign comparables.

B.2.3.4.14. To select the mix of functions and the level of market, comparables will generally be selected among companies performing the same or a similar mix of functions as the tested party and operating at the same level of market.

B.2.3.4.15. In considering the appropriate business mix, 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.

B.2.3.4.16. Comparables must be selected so that their financial performance reasonably reflects the scale of economies of the controlled party, depending upon the nature of the business. Size criteria in terms of sales, assets or number of employees are often used, as the size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore affect comparability.

B.2.3.4.17. 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.

B.2.3.4.18. Public or private companies reporting in a reasonably standard format with a detailed income statement and balance sheet data provide an objective baseline for subsequent analysis. Restricting the comparable search to public companies also has clear advantages. Many regulatory agencies around the world require filing of audited financial statements that conform to generally accepted accounting principles (GAAP). Also public companies provide considerably more detail in their audited financial statements and in the accompanying notes and management review of operations. Further, audited financial statements are available in a relatively consistent form over time, including retrospective restatement of data wherever necessary, which allows for the use of a multi-year statistical analysis that can be applied in prospective pricing decisions.

B.2.3.4.19. External comparables must be selected such that the relevant operations and available financial data appropriately reflect the business cycle and general economic circumstances 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.

B.2.3.4.20. 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.

B.2.3.4.21. 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.

B.2.3.4.22. The application of diagnostic ratios is based on the assumption that a diagnostic ratio reflects a value driver of a particular line of business and is a reflection of the comparable functional and risk profile. Most countries with transfer pricing rules acknowledge that the application of a net margin method is less sensitive to product and functional similarity than a traditional transaction method. However, functional comparability is still required in practice. Diagnostic ratios enable some of the features of a potential comparable that are economically relevant for the comparable search process to be taken into account when performing the comparable search.

B.2.3.4.23. In order to identify potential comparables with a similar functional and risk profile a diagnostic ratio measuring for example the level of wage costs compared to an appropriate base (e.g. total operating costs or total turnover) can be used as a yardstick to measure the level of technical manpower employed by comparable companies engaged in software development. The identification of a diagnostic ratio will depend upon several factors like geographical location; the nature of the business, product and services; the product and service market etc. Using diagnostic ratios may help to identify comparables which are in line with the functional and risk profile of the tested party.

B.2.3.4.24. The diagnostic ratio is applied by using cut-off criteria. With this method, financials of the tested party are used to calculate the diagnostic ratios and these ratios are then used to create minimum or maximum values to reject companies. Once a cut-off is determined, generally all the values above or below a particular range of the cut-off will be eliminated, depending upon the facts and circumstances of each case. Subsequently, based on the functional and risk profile of the tested party, all companies with a diagnostic ratio above and below the cut-off range will be excluded.

Approach to identifying potential comparables

B.2.3.4.25. In identifying potentially comparable uncontrolled transactions or enterprises two approaches are possible: the "additive" and the "deductive".

B.2.3.4.26. In the additive approach a list is prepared of potentially comparable uncontrolled transactions or of third parties which are believed to be carrying out potentially comparable transactions. The taxpayer then collects as much information as possible on these transactions to confirm whether they are in effect acceptable comparables, based on the five comparability factors for the controlled transaction. When adopting the additive approach special care should be taken in order to provide a reliable comparable; it is not sufficient that a third party company be well-known in the relevant industrial sector. Also, one needs to avoid potential third party companies who themselves have transfer pricing issues.

B.2.3.4.27. 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 advisory firms. The approach typically starts with a wide set of companies that operate in the same sector of activity, perform similar broad functions, and do not present economic characteristics that are obviously different.

B.2.3.4.28. It should be emphasized that the exclusive use of either of the two approaches may not yield valuable results. Depending on the facts of each case, one of the above two approaches can be used or both in combination.

B.2.3.4.29. It is possible that companies identified using the additive approach may not have been identified when using the deductive approach. This may in some cases 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.

B.2.3.4.30. It is very important that the taxpayer or tax administration using the "additive" and/or "deductive" approaches justifies and documents the criteria used to include or exclude particular third party data from the pool of potential comparables, in order to ensure a reasonable degree of objectivity and transparency in the process. In particular, the process should be reproducible by the taxpayer and by the tax administration that wishes to assess it. It is also very important that third party data be refined using qualitative criteria. It would be improper to use financial information relating to the transactions of a large sample of companies that have been selected solely because they are classified in a database under a given industry code.

Deductive approach: initial identification and screening of comparables

B.2.3.4.31. The next step, after having developed a set of comparability criteria that are tailored to the specifics of the controlled transaction at issue, is to conduct an initial identification and screening of potential independent comparables. The objective in this initial screening, where performed using a commercial database, is to identify substantially all companies that have a reasonable probability of demonstrating the threshold comparability requirements and of providing verifiable, objective documentary evidence of market pricing or profits. In other words, the desired initial result is to obtain the largest possible pool of potential independent comparables for subsequent screening, verification, and analysis. Where comparables are selected from information sources other than databases this part of the process may be different.

B.2.3.4.32. The process of screening, verification and selection of comparables will largely depend upon the availability of databases in the public domain in the country. Public databases may be available in some countries whereas other countries may not have these databases. In such cases, one of the options could be to rely on a database from a comparable economy with reasonable and reliable adjustments.

B.2.3.4.33. The following analytical needs and constraints should however be kept in mind:

- The search process should avoid any systematic biases;
- The screening process must be executed and documented in a manner consistent with the general requirement for due diligence; and
- It should be recognized that some of the initial comparables will be eliminated in subsequent stages of screening and analysis.

Secondary screening, verification and selection

B.2.3.4.34. Under this step, the search process focuses on a rigorous review of each transaction or company in the potential independent comparable pool against the full range of specific screening criteria. The objectives at this stage are verification, final screening and selection. This process is based on trial and error and requires multiple data sources, cross-checks and selected follow-up and confirmation of factual data.

B.2.3.4.35. The person performing the search for comparables may have to use a variety of information sources for third party or external comparables. These can include 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 completed a complete set of company financial statement data should be generated and reviewed for adequacy, period coverage and general consistency. Sometimes details may even be obtained through telephone or personal interviews with company management and it is also possible to 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.

B.2.3.4.36. There are various sources of data and information which are available to assist a taxpayer or tax administration in identifying potential comparables. Possible sources range from electronic databases to regulatory and other government filings and various analytical reports issued by trade and industry associations. The search objective is to identify the most reliable comparables for the controlled transaction under examination according to the specific set of criteria.

B.2.3.4.37. The data sources provide a vast array of information. Some provide simple leads or contacts, or a starting point to learn more about a particular industry so that appropriate comparables are ultimately selected. Others provide business profiles and detailed financial information about potential comparables. Each source can be important in establishing and documenting the quantitative basis for an arm's length transfer pricing policy.

B.2.3.4.38. A key resource among the general sources of information are electronic data compilations. These databases have been developed by various organizations which compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. Some of these databases compile financial data from one country only, while others compile regional or even global data. These products typically provide detailed financial information as well as some textual information such as short business descriptions, although the level of detail largely depends on the country concerned.

B.2.3.4.39. The advantage of electronic databases in the comparable search process is that they can provide the ability to sort quickly and retrieve selectively only the potential comparables that meet certain qualitative and quantitative screening criteria. Criteria commonly used for initial screening include industry codes, scale or sales volume, ownership and related/associated enterprises, availability of financial data or certain financial ratios.

B.2.3.4.40. Criteria commonly used for initial screening may include the following list. The relevance of the screening criteria below depends on the facts and circumstances of each particular case and the list here is purely indicative:

- Geographic restrictions with respect to a country or region;
- A specific industry classification;
- Certain keywords;
- Elimination of those enterprises which may have substantial transfer pricing issues themselves and fail an independence screening;
- Inclusion or exclusion of specific functions such as research and development, production, distribution or holding of shares;
- Exclusion of companies which were only recently set up;
- Consideration of diagnostic ratios such as turnover per employee, ratio of net value of intangibles/total net assets value or ratio of research and development/sales etc; and
- A focus on sales volume, fixed assets or numbers of employees.

B.2.3.4.41. It is important to note that electronic databases rely on publicly available information. These databases may not be available in all countries, since not all countries have the same amount of publicly available information about their companies. Further, due to the different disclosure and filing requirements depending on the legal form of the enterprise, the information may not be in a similar format, making it difficult to compare. Most of these databases are used to compare the results of companies rather than of transactions because third party transactional information is generally not readily available.

B.2.3.4.42. Commercial databases can be a practical and sometimes cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case. However, a number of limitations to commercial databases are frequently identified and commercial databases are not available in all countries. Further, they may be costly to use and many developing countries may not have access to them. The use of commercial databases is not compulsory and it may be possible to identify reliable comparables from other sources of information, including internal comparables as described above, or a manual identification of third parties (such as competitors) that are regarded as potential sources of comparables for the taxpayer's controlled transaction.

X Co is a subsidiary of software company Y Co based in Y Country 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.

Box Table 1: Functions performed

Description of functions	**X Co**	**Y Co (AE)**
Product R&D, design and concept	-	⊛⊛⊛
Testing of the product	⊛	⊛⊛⊛
Marketing function	-	⊛⊛⊛
Service function	⊛⊛	⊛

After-sale function	-	⊛⊛⊛
Accounts function	⊛⊛⊛	-

Box Table 2: Assets employed relating to X Co's operation

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

Box Table 3: 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 the risk of collecting receivables from the clients.
Service level quality risk	⊛⊛⊛	-	
Working capital risk	-	⊛⊛⊛	X Co is compensated by the AE in advance and hence, is not required to seek finance to fund its working capital.
Foreign currency risk	⊛⊛⊛	-	
Material risk	-	⊛⊛⊛	
Software technology risk	-	⊛⊛⊛	
Human capital risk	⊛⊛⊛	-	

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

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

Box Table 4: Steps in selection process

Criteria	Number of companies passing the criterion	Explanation
Company's main economic activity	764	Company primarily engaged in providing computer software, software services and consultancy
Financial data as of March 2007 onwards	411	Companies where the latest data is not available have been excluded
Sales > US$ 10 Million	280	To eliminate companies whose sales are less than US$10 Million
Wages to sales ratio[a]	157	To eliminate companies whose wages to sales ratio is less than or equal to 25 per cent

Qualitative analysis	8	Companies which fall under the category of "different line of business activity", "related party transactions", "loss making" (an average loss over a 3 year period)[b] and "data unavailable for review" were not considered.

[a]This criterion is used here due to the fact that the company under review engages in the provision of services, which assumes the need for a significant work force. Wages are therefore a major factor in the revenue earned, and thus these criteria can be used in specific situations in the process of elimination.

[b]This is for the purpose of this example and does not mean that loss-making comparables should always be excluded. See Paragraphs B.2.4.4.2. and B.2.4.5. for discussion of losses.

B.2.3.4.43. There are other sources of comparable data available. These provide a more detailed business mix, product line, geographic market, functional mix and ownership information on the first-round selection of potential comparables. They also help 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 organizations — often these institutions or organizations will maintain databases and research reports, and/or hold files with data on potential comparables. Generally these institutions or organizations would be:
    - Chambers of commerce;
    - Trade and professional organizations;
    - Embassies, consulates or trade missions; or
    - International organizations (e.g. the United Nations, the Organisation for Economic Cooperation and Development, the World Bank, the International Monetary Fund).

B.2.3.4.44. The following example addresses the practical application of screening.

B.2.3.5 Adjustments to Comparables

B.2.3.5.1. Certain adjustments may be needed in order to satisfy the requirements for accuracy and reliability of the comparables so that the financial results of the comparables are stated on the same basis as those of the tested party. However, the following important issues may be considered before an adjustment is made:

- Quality of data being adjusted: the comparability adjustment may only be applied where it can improve the reliability of comparables. If the search process for comparables has major shortcomings, adjustments may not be applied to poor comparables which would require too many adjustments;
- Purpose of adjustment performed: differences that have no material effect on comparability should not be adjusted;

- Not every transaction being compared is capable of being adjusted: there are transactions that may be adjusted but some other transactions like those concerning goodwill or intangibles may not be capable adjustment;
- Reliability and accuracy of the adjustment: the adjustment should be calculated based on objective and verifiable data; and
- Documentation: comparability adjustments are part of the comparability analysis and should be appropriately documented in order to ensure its reliability.

B.2.3.5.2. Comparability adjustments can be divided into the following three broad categories:

1. Accounting adjustments;
2. Balance sheet/working capital adjustment;
3. Other adjustments.

B.2.3.5.3. Accounting adjustments. There are various types of difference in accounting standards and practices between the tested party and third parties used as comparables which may lead to measurement errors if adjustments are not made. The accounting differences can be grouped under the following categories of classification differences and differences under relevant law or standards.

B.2.3.5.4. Accounting differences may relate to classification where certain operations are recorded in different accounting lines. For example:

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

B.2.3.5.5. Other accounting differences under relevant law or standards relate to situations where a comparable or tested party may have a choice under relevant law or standards to capitalize or expense certain costs like R&D expenses. Thus, a company may have developed significant intangibles but have no intangible property in its assets on the balance sheet. Similarly, different accounting law or standards may be applicable to goodwill recognition and amortization which may create significant discrepancies between the comparables and the tested party. In many cases it is difficult to identify differences in accounting standards due to the following reasons:

- Limited amount of detail available with regard to comparables in the public domain;
- Potential inconsistencies in the reporting of company financial data by private reporting services;
- Inconsistencies among methods of reporting among companies; and

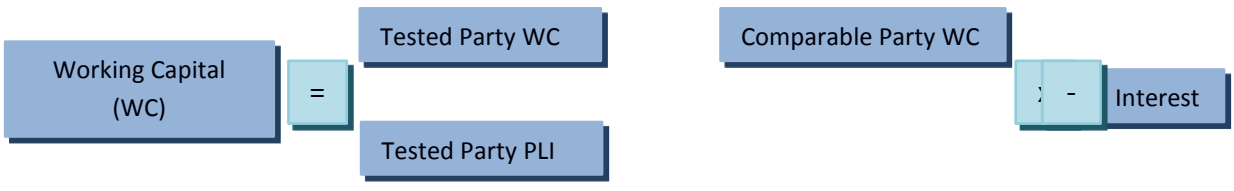
- Different accounting standards followed in different countries.

B.2.3.5.6. Balance sheet adjustments are intended to account for different levels of inventories, receivables, payables, interest rates, etc. The most common balance sheet adjustments, made to reflect differing levels of accounts receivable, accounts payable and inventory, are known as working capital adjustments. The fact that balance sheet adjustments are found most commonly in practice does not mean that they should be performed on a routine or mandatory basis. A significantly different level of asset intensity may require further investigation of the comparability characteristics of the potential comparable and merely making a working capital adjustment would not alleviate the problem.

B.2.3.5.7. It is very common for the tested party and each of the potential comparables to differ materially in the amount of working capital (inventory, accounts receivable and payable). Such differences are generally caused by differences in the financing terms of purchases and sales that the company receives from its suppliers and extends to its customers, and by differences in the levels of inventory held by the company. Such differences may generate substantial differences in the working capital structure and may have an impact on the operating profits of the companies due to the financing costs. In order to reduce the effect of differences in terms of purchases and sales and levels of inventory on profitability, adjustments can be made to reflect the time value of the receivables, payables, and inventory of the comparables. This, however, should be done only if such adjustments can be reasonably made and they improve comparability.

B.2.3.5.8. Adjustments for inventory, accounts receivable and accounts payable follow the same basic mechanics. First a value is calculated as the difference between the ratio of the balance sheet item in question to net sales for the comparables and the same ratio for the tested party. The denominator of these fractions will be an arm's length amount for the tested party, for example the denominator of a Profit Level Indicator (PLI) can be used. An alternative approach would be to calculate these ratios with respect to operating expenses such as where gross profit/operating expenses are the PLI used. The resulting difference in the ratios is then multiplied by an interest rate and by the net sales of the comparables to generate an amount to adjust the income statements of the comparables. Then the PLI of that comparable is recomputed.

B.2.3.5.9. The following example shows how the results of the comparable are adjusted to reflect the tested party's levels of working capital. The other approach could be that calculations are made to adjust the tested party's results to reflect the comparable's levels of working capital or to adjust both the tested party's results and the comparable's results to reflect "zero" working capital. In general, working capital adjustments are calculated for inventory, trade receivables and trade payables. The method for calculating working capital adjustments for all three accounts follows the same basic approach. To begin with, a value is calculated for differences in levels of working capital between the tested party and the comparable party relative to the appropriate base. The appropriate base will be the denominator used for calculating the PLI which can either be costs, sales or assets. The resulting difference in the ratios is then multiplied by an appropriate interest rate. A working capital (WC) adjustment so computed is either adjusted to the comparable's PLI or to the Tested Party's PLI for the purpose of comparison.



Comparable Party PLI

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

Box Table 5: Working capital adjustment

Particulars	Tested Party	Comparable Party
Sales (A)	100	120
Earnings before interest and taxes (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%

B.2.3.5.10. Other Adjustments are those 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.

B.2.3.5.11. The **financial results of the comparables** may need to be adjusted to eliminate the effect of such differences. Such adjustment is possible only when reliable and accurate segmented detailed information is available. An adjustment is made to the revenue and costs relevant to the functions performed by the comparables but not by the tested party. If an arm's length return is established for additional functions performed by the tested party, it is not necessary to adjust the comparables. That arm's length return based on another set of comparables may be applied to the tested party for those

functions. Care should be exercised while making a functional adjustment which involves a subjective assessment.

B.2.3.5.12. There can be significant differences in the mix of functions performed by the potential comparable vis-à-vis the tested party. For example, a controlled distribution company may differ from a set of independent distribution companies in that it performs import and regulatory functions not performed by the independent distributors (notwithstanding that the independent distributors have been determined to be the best available comparables); performs only first-tier distribution functions and performs limited manufacturing and assembly functions. To adjust for such differences, the financial results of the comparable may be adjusted to account for the revenue, costs, and associated profits associated with the functions performed by the comparable but not by the tested party, or vice versa.

B.2.3.5.13. Adjustments performed to adjust for material differences in the mix of functions performed by a controlled storage device distributor and a set of independent storage device distribution comparables is considered here to illustrate this point. It is assumed that the independent device distributors (determined to be the best available comparables) also perform manufacturing/assembly operations and downstream distribution functions that are not performed by the controlled storage device distributor. In this case, the financial results of the comparables may need to be adjusted to eliminate the profits associated with manufacturing/assembly operations and with downstream distribution functions based upon the profitability earned in uncontrolled comparable storage manufacturing and downstream distribution transactions. In other words, for comparability purposes, only the functions comparable to the functions carried out by the controlled storage device distributor should be taken into consideration.

B.2.3.5.14. To contrast the treatment above with a different set of circumstances, it is assumed that the controlled storage device distributor above performs some import functions which are not performed by the independent distributors. The margins of those comparables that did not perform import functions would, in these circumstances, need to be adjusted to reflect an arm's length profit associated with these functions.

B.2.3.5.15. Where a significant part of the potential comparable's profits is attributable to **significant, unique intangibles**, such as unique product design or unique engineering, that are not present in the tested party, it may not be possible to eliminate the effects of such intangibles on operating profits by performing reliable comparability adjustments. In such cases, the potential comparable may need to be rejected.

B.2.3.5.16. As suggested earlier **economically significant risk** is related to anticipated reward and it would be expected that this would be reflected in a controlled transaction that satisfies the arm's length principle. However, the actual return may or may not increase depending on the degree to which the risk is actually realized. As such, similarity in the level of risk is an important consideration in selecting comparables.

B.2.3.5.17. The degree of comparability between a tested party and an uncontrolled taxpayer is impaired when the entities assume different economically significant risks which may require making a risk adjustment. For example, a contract manufacturer in certain circumstances does not usually assume the market risk that full-fledged manufacturers customarily do.

B.2.73.5.18. There is no universally accepted method for risk adjustment. However, in practice MNEs carry out risk adjustment through the application of certain methods that attempt to quantify on an *ex ante* basis (i.e. before the event) the effect of risk on anticipated profitability based on, for example, the weighted average cost of capital/capital asset pricing model. However it is worth mentioning that both models are based upon risk models used mainly in relation to the risk of securities. Most statistical methods have their inherent limitations. Therefore, risk adjustment must be made carefully, only where needed and only if a reasonable and accurate adjustment is possible.

B.2.3.5.19. It has to be recognized that problems can arise due to significant differences in the **transactional structure** between associated party sales in a controlled company and similar transactions involving independent companies.

B.2.3.5.20. These problems typically arise in controlled situations when the parties allocate the risks and functions of the enterprise among themselves differently from the allocation of risks and functions between independent enterprises. The differences in the bargaining power and degree of common interest of the associated parties and the independent companies may lead to very different transaction terms, such as extremely long-lived contracts, or instances where transfers of unique intangibles that would not ordinarily be transferred between independent companies are undertaken between the associated enterprises.

B.2.3.5.21. 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 on long-term contracts, unless an adjustment is made to account for the short duration of the former.

B.2.3.5.22. It has to be stressed that comparability adjustments should be considered if and only if they are expected to increase the reliability of the results. Relevant considerations in this regard include the materiality of the differences for which an adjustment is being considered, the quality of the data used in the adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.

B.2.3.5.23. 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.

B.2.3.5.24. No specific rules or guidelines can be given that may be applicable to every transaction or indicate that comparability adjustments must be made. In each case, the critical factors that have a material impact on the price of the product (if the Comparable Uncontrolled Price Method is used) or on profit (if the Resale Plus Method, Cost Plus Method, Transactional Net Margin Method or Profit Split Method is used) should be identified. Ultimately, this decision depends entirely on the facts and circumstances surrounding the transactions, on the availability of information needed for the analysis and on the accuracy and reliability of any adjustments that may be made.

B.2.3.5.25. Available information is often not complete enough to enable a review to be made of each possible comparability factor. The analysis almost always takes place with imperfect information. That

realization can be helpful in deciding whether a particular difference is material enough to make adjustments, or whether the comparability difficulties should affect the selection of the most appropriate method.

B.2.3.6. Comparability Considerations in the Selection of Transfer Pricing Methods

B.2.3.6.1. The degree of comparability between the controlled and the uncontrolled transactions, including the reliability of comparability adjustments needed and the availability of reliable information (especially on uncontrolled comparables) are key factors in selection of the most appropriate transfer pricing method. Other factors include the strengths and weaknesses of the method, the appropriateness of the method in the light of the nature of the controlled transaction (based upon a functional analysis), etc. For further information see Chapter B.3.

B.2.3.6.2. Once the taxpayer has identified the transfer pricing methods that are potentially applicable to the controlled transaction, application of the most appropriate method rule involves a careful balance in which the following factors may be taken into account to assess the relative accuracy of the identified methods:

- The extent to which the comparability factors (characteristics of the property or services, functional analysis, contractual terms, economic circumstances and business strategies) of uncontrolled transactions or entities are similar to the controlled transactions or entities, given the type of comparability that is required under each pricing method;
- The availability and reliability of financial and other information that is known about the comparable;
- Reliability and accuracy of the comparability adjustments; and
- Reliability of presumptions as well as deficiencies in data and presumptions.

B.2.3.7. Determination of an Arm's Length Price or Profit (or Range of Prices or Profits)

B.2.3.7.1. 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 Part B.3. on Methods.

B.2.3.8. Documentation of the Comparability Analysis and Monitoring

B.2.3.8.1. Another important and necessary requirement while performing the comparability analysis is to maintain complete documentation of the analysis, evaluation and selection (as well as rejection) of comparables along with a substantiation of the adjustments, if any, made. Complying with documentation requirements may be a significant but unavoidable burden for the taxpayer. ChapterC.2. deals in detail with documentation requirements.

B.2.4 Issues Regarding Comparability Analysis

B.2.4.1. General

B.2.4.1.1. The comparability analysis should be as reliable as possible and on many occasions does not tend to yield perfect matches in terms of comparable enterprises or comparable transactions to those carried out by the associated enterprises. The nature, type, quality, etc and number of comparables along with the adjustments made during a comparability analysis may be the subject of debate, interpretation and contention between the taxpayer and tax authorities. The key concerns surrounding comparability analysis are described below.

B.2.4.2. Timing Issues

B.2.4.2.1. 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.

B.2.4.2.2. **Timing of origin** of the transactions needs to be considered. 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.2.4.2.3. **Timing of collection** of the relevant comparable data is also a key issue. In some cases taxpayers implement 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 is however not the most common approach.

B.2.4.2.4. In other instances, taxpayers might test the outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm's length principle, i.e. on an ex post basis (hereinafter "the arm's length outcome-testing" approach). This test typically takes place as part of the process for establishing the tax return at the year-end. An ex post (after the event) analysis is the most commonly used method to test the arm's length price of international transactions.

B.2.4.2.5. The arm's length price-setting and the arm's length outcome-testing approaches, as well as combinations of these two approaches, are found among countries that have implemented transfer pricing rules. Country views differ as to whether data on contemporaneous transactions which only become available to the taxpayer and tax administration at the time of filing of the tax return, or conducting ex post analysis of transfer pricing is permitted or represents improper use of hindsight.

B.2.4.2.6. Another key question is whether, and if so how, to **take into account future events in the transfer pricing analysis**. Such events were not predictable 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.

B.2.4.2.7. The main issue is to:

- Determine whether the valuation was sufficiently uncertain at the outset that the parties at arm's length would have required a price adjustment mechanism; or
- Whether because the change in value was so fundamental, or other developments arose, this would have led to a re-negotiation 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 consideration of what independent enterprises would have done or agreed between them.

B.2.4.2.8. **Data from years following the year of the transaction** may also sometimes be relevant to the analysis of transfer prices, but care must be taken to avoid the use of hindsight, perceiving the significance of facts and events with the benefit of knowledge accruing after they have occurred.

B.2.4.3. Lack of Reliable Comparables

B.2.4.3.1. One of the most frequent problems taxpayers and administrations face with comparability analysis is the lack of reliable comparables with respect to the transaction(s).

B.2.4.3.2. The lack of comparables for a taxpayer's controlled transaction is not determinative in that it does not mean that such transaction is or is not at arm's length or that the arm's length principle is not applicable to that transaction. In some instances where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to determine whether the conditions of the transaction are such that they 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.

Absence of data

B.2.4.3.3. In many developing countries, reliable comparable transactions simply may not be available. This may be due to the fact that a particular sector was only recently liberalized by the government or due to the advent of a new sector or industry in the region. The available comparable transactions in such cases are at best inexact and have to be adjusted to arrive at a reasonable degree of comparability. It may be possible under certain circumstances to use foreign comparables, possibly

adjusted, to deal with these situations, but even then the administration may not have access to relevant databases and is therefore very reliant on the taxpayer's use of the data.

B.2.4.3.4. 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.

B.2.4.3.5. Comparable data may not be available in the public domain in many developing countries, or there may not be enough resources or processes in place to collate and make available such data for public consumption. It may be possible under certain circumstances to use foreign comparables, possibly adjusted, to deal with these situations.

Use of new technologies, products and services, impact of business consolidation

B.2.4.3.6. 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 (CPM, RPM 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.

B.2.4.3.7. Owing to consolidation and vertical integration, it may be extremely difficult in some industries to find reliable internal or external comparables. An example is the pharmaceutical industry where there exists a high level of vertical integration and consolidation in order to drive up efficiencies. In such scenarios the controlled transactions are part of a larger global supply-chain and it can be difficult to find comparable transactions between independent enterprises. In such cases also, it may be possible under certain circumstances to use comparables from other industries, possibly adjusted, in order to address this issue.

B.2.4.4. "Cherry-picking" of Comparables

B.2.4.4.1. It is frequently not possible to obtain information on perfect comparables in practice, 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, ignoring other information that does not support the position argued for.

B.2.4.4.2. For example, extreme results may be rejected as comparables after careful consideration by the tax authorities as they tend to skew the data. While this could on the one hand be a correct application of the arm's length principle in certain circumstances, on the other hand the reasons for a loss may be genuine and may not always justify rejecting the loss-making company from the pool of comparables. This may be for example 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 a start-up phase while the associated enterprise is also in a comparable start-up phase, etc.

B.2.4.4.3. 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.

B.2.4.4.4. Well-documented search procedures and comparability criteria make the comparability standard transparent, in that the comparability standard that was applied is clearly stated and its scope can be evaluated. This will ensure that results are less susceptible to "cherry picking" since the reasons for rejection of each potential comparable are provided.

B.2.4.5. Losses

B.2.4.5. 1. Analysis of the losses of an enterprise in an MNE group is an important process both in selection of comparables and in making comparability adjustments to the tested party or comparables. This requires careful scrutiny focusing on the type and nature of the losses, period of loss-making and the reasons for such losses. In an MNE group one of the enterprises may be suffering a loss, even a recurring one, but the overall group may be extremely profitable. An enterprise that is doing business with profitable members of its MNE group while generating losses itself may warrant scrutiny by the tax authorities concerned. Such a situation may indicate that the loss-making enterprise is not getting adequate compensation from the MNE group in respect of its activities.

B.2.4.5. 2. The tax authorities must appreciate the fact that the losses discussed in the above paragraph, if short-term, may be the result of a deliberate business strategy for market penetration. Nevertheless, in such cases the question of who will bear the cost of market penetration should be carefully examined. For example, the allocation of market penetration expenditure to a limited risk bearing entity is questionable. The expenditure may be more correctly allocated to another company in the MNE group, as limited risk entities typically do not engage in such entrepreneurial activity.

B.2.4.5. 3. There could be a number of causes for losses. The most common include:

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

B.2.4.5. 4. The losses discussed in the previous paragraph 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 at a profit. Losses in particular product lines arise for a variety of reasons, including increased competition, product lines at the beginning or end of their life-cycle or quality issues.

B.2.4.5. 5. 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.

B.2.4.5. 6. Deliberate business strategies: An MNE might undertake deliberate business strategies for market penetration to increase market share and profit potential, resulting in losses in some jurisdictions. However, such business strategies may only justify losses for a limited 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 an MNE group. In uncontrolled circumstances the limited risk bearing entity is not likely to absorb the costs of a market penetration strategy.

Losses caused by recession

B.2.4.5. 7. Whether an entity should share or absorb the losses of a recession will depend upon the facts of each case. Three important issues arising from a recession need to be examined to determine the appropriate allocation of such losses.

B.2.4.5. 8. The impact of a recession may vary from country to country; for example in the year 2009, the recession was experienced more in developed countries as compared to emerging economies. Accordingly, the location of the associated enterprise is an important factor in deciding the question of sharing the losses of an MNE group. Profitability may also vary across industries. While a particular industry may experience significant losses other industries may not be hit by the recession. This may be a relevant factor if the best available comparables are in a different market or industry.

B.2.4.5. 9. The sharing or absorption of the losses due to a recession will depend upon the risk profile of an entity. Sharing of such losses by risk-free or limited risk bearing entities would generally be unreasonable.

B.2.4.5. 10.Support payments and associated loss transfers will require close scrutiny of the inter-company agreement. It is possible that an MNE may sell to customers at a loss due to a sharp decline in customer demand in a recessionary market, in order to protect its market share. At arm's length, the sharing of such losses between the associated enterprises will depend upon the contractual risk profile of each. It is reasonable to assume that a limited risk or risk free distributor would not share in such losses at arm's length.

B.2.4.5. 11.Losses may arise from increased competition. Sometimes a product faces competition because the 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 "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.

B.2.4.5. 12.Losses may occur due to product life-cycle issues. The 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 (realization of economies of scale) which may result in the manufacturer incurring losses. At the other end of the life cycle one of the choices for the MNE is to retain the products to offer a complete product line to customers even though the products may have been replaced by newer technology. However, in this case attributing the overall loss to the risk bearing entity may require further scrutiny. Any losses in the growth and maturity stage may involve intensive scrutiny by the tax administration because losses in these phases are most unlikely.

B.2.4.5. 13.Losses arising from quality issues are another key concern. Poor quality ordinarily arises from design-related activities, R&D or from manufacturing issues. In the latter case, depending upon the facts and circumstances, including the risk profile of the entities in question, the arm's length position can be that the manufacturing affiliate is expected to bear the losses arising from its manufacturing activities. The party responsible for the design or R&D, depending upon the facts and circumstances including the risk profile of the entities in question, may need to bear the losses arising from that faulty design or R&D.

B.2.4.6. Intentional Set-offs

B.2.4.6. 1. A deliberate or intentional set-off occurs when an associated enterprise has provided a benefit to another associated enterprise within the MNE group and is compensated in return by that other enterprise with some other benefits. These enterprises may claim that the benefit each has received should be set-off against the benefit each provided and that only the net gain or loss if any on the transactions needs to be considered for tax assessment.

B.2.4.6. 2. Set-offs can be quite complex; they might involve a series of transactions and not just a single transaction or at least two parties to set-off. Ideally the parties disclose all set-offs accurately and have enough documentation to substantiate their set-off claims so that after taking account of these the conditions governing the transactions are consistent with the arm's length principle.

B.2.4.6. 3. The tax authorities may evaluate the transactions separately to determine whether the transactions satisfy the arm's length principle. However, the tax authorities may also choose to evaluate the set-off transactions together, in which case comparables have to be carefully selected. Set-offs in international transactions and in domestic transactions may not be easily comparable, due for example to the asymmetries in the tax treatment of the set-offs under the taxation systems of different countries.

B.2.4.7. Use of Customs Valuations

B.2.4.7.1. The price paid or payable for the goods (and under certain circumstances services — the so-called "adjustments") in import transactions is the starting point for determination of the assessment of customs duties. A higher price on import reduces the profit and thus the direct tax, while a low price on import lowers the customs duty. Accordingly, there may be perhaps an inherent conflict between the revenue implications and the motivation of the customs and direct tax authorities. While

the direct tax authority may seek to lower the price on import to stop diversion of profit, the Customs authority will seek to ensure that the declared Customs value has not been undervalued to reduce duty liability.

B.2.4.7.2. The WTO Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 ('the Agreement') sets out the methodology for determining the Customs value of imported goods. Customs valuation is the procedure applied to determine the customs value of imported goods for the purpose of calculating ad valorem customs duties. Members of the WTO are required to give effect to the Agreement in national legislation[3]. The tax authorities in most of the member countries use the "arm's length principle" as a standard as set out in OECD Transfer Pricing Guidelines. It is important to note here that both the methodologies set by the WTO and OECD aim at determining a price for related party transactions, as if the parties were not related; the approaches of the Customs authorities and direct tax authorities are however often different and incompatible due to different motivations, theoretical frameworks, documentation requirements and other factors. There is a need to achieve a convergence of transfer pricing and customs valuation through better coordination and exchange of information between these two authorities.

B.2.4.7.3. In appropriate circumstances the verified customs value 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. In particular, Customs may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction. Some Customs administrations are now making use of transfer pricing data, as appropriate, to ensure that the price of an associated party transaction has not been affected by the special relationship between the parties. Customs authorities may use comparisons between the value attributable to goods imported by associated enterprises and the value for identical or similar goods imported by independent enterprises, where available, or alternatively may examine the circumstances surrounding the sale. 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.

B.2.4.7.4. Even when utilizing import customs values in a transfer pricing context, certain additional upward or downward adjustments may be required to derive the arm's length price for the purpose of direct taxation. Such adjustments may have an impact on the customs value.

B.2.4.7.5. There is a great deal of focus internationally on the interplay between transfer pricing and customs valuation methods. Following two joint World Customs Organization (WCO)-OECD conferences in 2006 and 2007, it became clear that harmonization of the two systems was not a realistic proposition, particularly given the fact that the WTO Valuation Agreement is not expected to be updated in the short to medium term. Discussions have therefore focused on the extent to which Customs may use transfer pricing information when carrying out examination of related party transactions. The Technical Committee on Customs Valuation, which has the mandate for ensuring, at the technical level, uniformity in interpretation and application of the Agreement, has issued two instruments on this topic: Commentary 23.1, which recognises the principle that a transfer pricing study may be used by Customs as a basis for examining the circumstances of the sale, on a case by case

[3] See http://www.wto.org/english/tratop_e/cusval_e/cusval_e.htm

basis; and Case Study 14.1, which sets out a scenario where Customs use transfer pricing data, based on the transactional net margin method, to confirm that a related party transaction has not been influenced by the relationship between the parties[4].

B.2.4.7.6. The WCO has produced a Guide to Customs Valuation and Transfer Pricing[5] which includes all relevant technical information on the two methodologies and explores the interaction between them. It includes good practices for Customs and tax administrations, and businesses. In particular, Customs and tax administrations are encouraged to work more closely together and the guide emphasises that businesses should consider Customs' needs when developing transfer pricing strategies. To this end, the WCO has produced Guidelines for Strengthening Cooperation and the Exchanging of Information between Customs and Tax Authorities at the National Level[6]. These Guidelines endeavour to provide guidance and ideas to Customs and Tax authorities for formalising the contacts and strengthening the existing cooperation at the national level, on a range of issues of mutual interest.

B.2.4.8. Use of Secret Comparables

B.2.4.8. 1. Concern is often expressed by taxpayers, especially MNEs, over aspects of data collection by tax authorities and its confidentiality. Tax authorities have access to, as they need to, very sensitive and highly confidential information about taxpayers, such as data relating to margins, profitability and business contracts. Confidence in the tax system means that this information needs to be treated carefully, especially as it may reveal sensitive business information about that taxpayer's profitability, business strategies and so forth.

B.2.4.8. 2. A secret comparable generally refers to the use of information or data about a taxpayer by the tax authorities to form the basis of transfer pricing scrutiny of another taxpayer. The taxpayer under scrutiny is not given access to that information — it may, for example, reveal confidential information about a competitor (i.e. the first taxpayer — to which the data relates).

B.2.4.8. 3. There is a need to exercise caution against the use of secret comparables unless the tax administration is able, within the limits of its domestic confidentiality requirements, to disclose the data to the taxpayer whose transactions are being reviewed. This would enable an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts. Taxpayers contend that the use of such secret information is against the basic principles of equity, as the taxpayer is required to benchmark its controlled transactions with comparables not available to it, without the opportunity to question comparability or argue that adjustments are needed. Taxpayers contend that it would be unfair if they face the consequences of adjustments made on this basis, such as additions to income, typically coupled with interest, penalties etc. Furthermore, double taxation may not be relieved if secret comparables cannot be disclosed to the Competent Authority of another country.

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[4] Available in the WCO Valuation Compendium, via the WCO Bookshop: http://wcoomdpublications.org/valuation.html

[5] Available to download here : http://www.wcoomd.org/en/topics/valuation/instruments-and-tools/guide-to-customs-valuation-and-transfer-pricing.aspx

[6] Available to download here : http://www.wcoomd.org/en/topics/facilitation/instrument-and-tools/tools/guidelines-on-customs-tax-cooperation.aspx

B.2.4.9. Overall Process Complexity

B.2.4.9.1. Comparability analysis looks simple in theory but in practice it can be a laborious, difficult, time-consuming and, more often than not, expensive exercise. Seeking information, analyzing all the data from various sources, documenting the analysis and substantiating adjustments are all steps that require time and money. It is therefore important to put the need for comparability analyses in perspective. The aim should be to ensure that the compliance burden and costs borne by a taxpayer to identify possible comparables and obtain detailed information thereon are reasonable and proportionate to the complexity of the transaction. It is recognized that the cost of obtaining information can be a real concern, especially for small to medium sized operations, but also for those MNEs that deal with a very large number of controlled transactions in many countries. However, it should be observed that the burden of cost cannot be a reason for the dilution of comparability standards.

B.2.4.9.2. These resource considerations apply at least as much to many developing countries, and efforts must be made to ensure that their position is not prejudiced by a lack of such resources in ensuring the arm's length pricing of transactions in their jurisdictions.

B.2.4.9.3. When undertaking comparability analysis there is no requirement for an exhaustive search of all possible relevant sources of information. Taxpayers and tax administrations should exercise judgement to determine whether particular comparables are reliable.

B.2.5. Conclusion

B.2.5.1. Transfer pricing theory meets practice in comparability analysis — the translation of the arm's length principle into the selection of reliable comparables and of the appropriate transfer pricing method, eventually yielding the transfer price. This is all facilitated by comparability analysis.

B.2.5.2. A good comparability analysis is an essential step in any transfer pricing analysis in order to gain a correct understanding of the economically significant characteristics of the controlled transaction, and of the respective roles of the parties to the controlled transaction. This will assist in the selection of the most appropriate transfer pricing method in the circumstances of the case. This part of the process is fact-based and requires the taxpayer or tax administration to demonstrate an understanding of how business operates.

B.2.5.3. 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 particularly complicated, especially in countries that have limited access to information on potential comparables. It is worth emphasizing 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.

B.2.5.4. It is clear that the comparability analysis should be as reliable as possible so as to arrive at the correct arm's length price or profit (or range of prices or profits). In performing 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, other factors and, if necessary, a series of comparability adjustments while arriving at a suitable set of benchmarks (or comparables).

The choices made in the course of this analysis have to be substantiated and the overall process has to be thoroughly documented.

B.2.5.5. It is essential to put the need for comparability analyses into perspective given the extent of the compliance burden and costs that can arise to a taxpayer or tax administration in identifying possible comparables and obtaining detailed information. Taxpayers and tax administrations should exercise judgment to determine whether particular comparables are reliable.

B.2.5.6. Furthermore, as noted in the introduction, the lack of comparables for a given controlled transaction does not mean that it is or is not at arm's length or that the arm's length principle cannot be applied. 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.