Transfer Pricing

APPLICATION OF THE ALP: COMPARABILITY ANALYSIS

Comparability Analysis

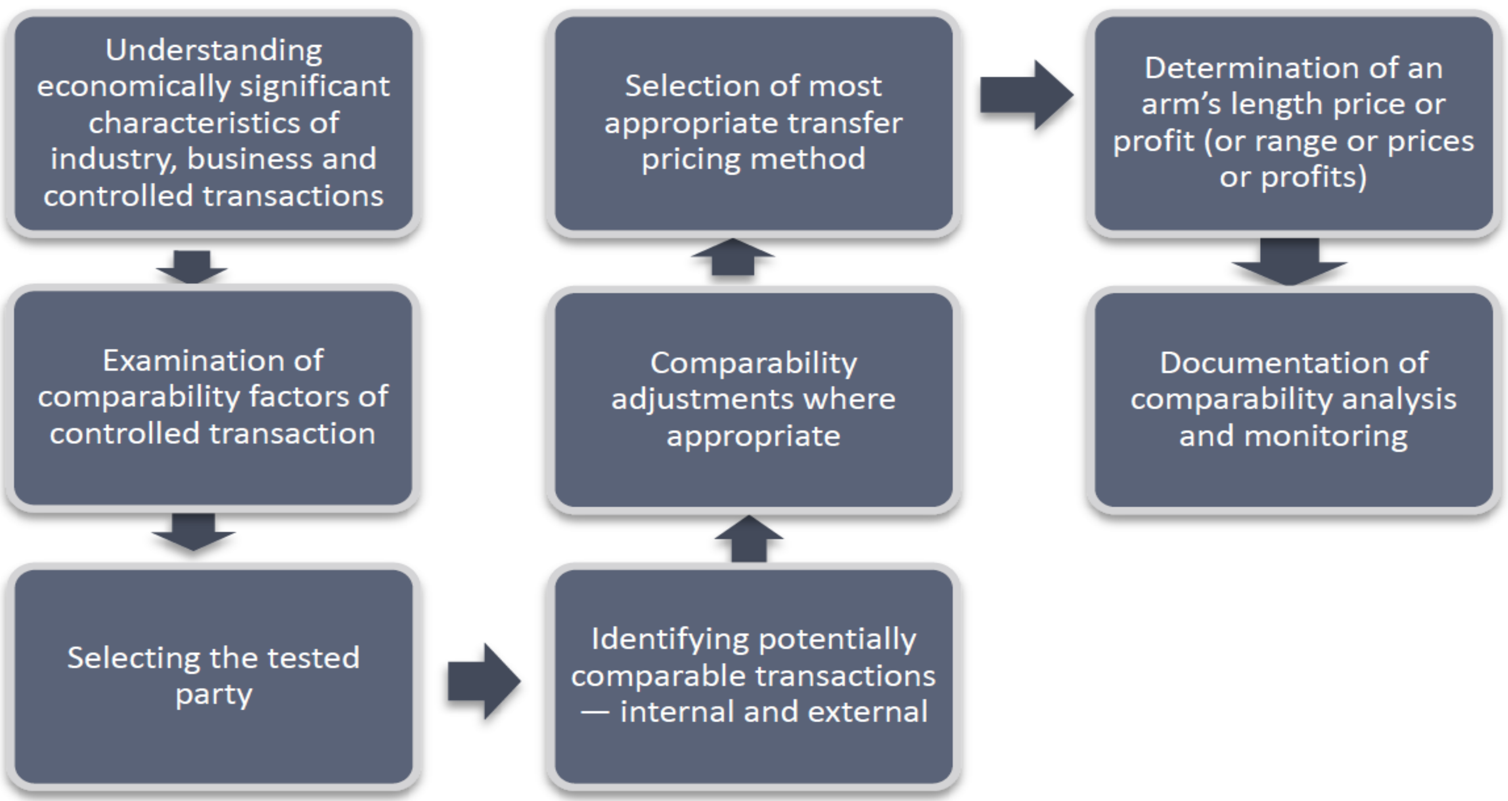
- The **Comparability Analysis** is the heart of the application of the ALP;

- The application of the ALP is based on a comparison of the conditions:

  - in a **controlled transaction**; with

  - the conditions that would have been made had the parties been **independent** and undertaking a comparable transaction under comparable circumstances.

Steps in the comparability analysis process



Comparability Factors

- **Examination of comparability factors relevant to the controlled transaction**:

1. **Contractual terms** of the transaction;
2. **Functions** performed by each of the parties to the transaction (taking into account **assets used** and **risks assumed**, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices);
3. **Characteristics of property** transferred or **services** provided;
4. **Economic circumstances** of the **parties** and of the **market** in which the parties operate;
5. **Business strategies** pursued by the parties.

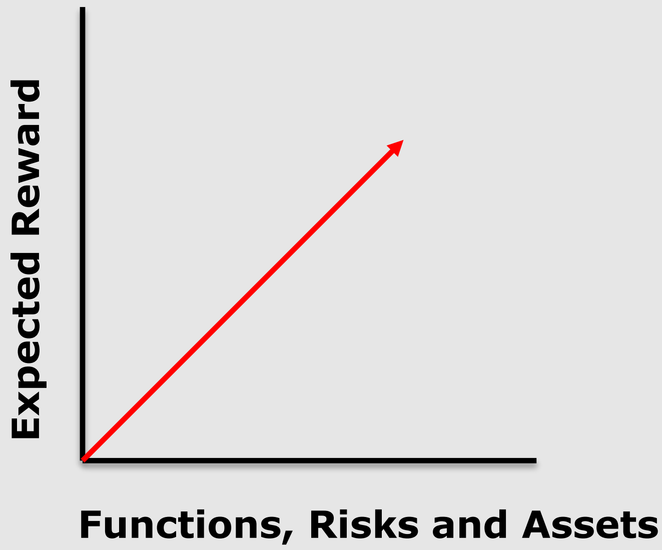
1. Contractual Terms

- **What** is important?
  - Quality and quantity;
  - Responsibilities and obligations;
  - Risks;
  - Price and other commercials (e.g., delivery terms);
  - Penalties;
  - Payment terms and conditions.
- **Why** is it important?
  - Contractual terms of a transaction define how the responsibilities, risks and benefits are to be divided between the parties;
  - Helps to determine factors which could have influenced the price and calculate necessary adjustments;
  - **BEPS**.

2. Functional Analysis

- **Assumption**
  - In transactions between two independent enterprises, compensation usually reflects the functions that each enterprise performs (taking into account assets used and risks assumed)

- **Scope**
  - The functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions



2. Functional Analysis

- **Actions 8-10 has introduced a new guidance on the analysis of risks based on the following framework**:

1. Identify **economically significant risks**;
2. Determine how these **specific risks** are **contractually assumed** by the parties;
3. Determine, through the **functional analysis**, how the parties operate in relation to the **assumption** and **management** of these **specific risks**;
4. **Price** the accurately delineated **transaction**, taking into account the appropriate **allocation of risks**.

2. Functional Analysis

Identification of Risks

Contract Analysis

Functional Analysis

- Do the parties follow the contractual terms?
- Does the party assuming the risk exercise control over the risk and have the financial capacity to assume the risk?

YES

Pricing of the Transaction

NO

Risks Allocation

- **Financial Capacity**
- **Control over the Risk**

3. Characteristic of Property or Services

- **What** is important?
  - Characteristics of **property**:
    - Physical features;
    - Quality and reliability;
    - Availability and volume supply;
  - Characteristics of **services**:
    - Nature of services;
    - Scope of services;

- **Why** is it important?
  - Differences in the specific characteristics of the property or services often account, at least in part, for their price differences in the open market;

4. Economic Circumstances

- **What** is important?
  - Market comparability includes:
    - Geographic location;
    - The size of the markets;
    - The extent of competition;
    - Availability of substitute goods and services;
    - Levels of supply and demand;
    - Consumer purchasing power.
- **Why** is it important?
  - Arm’s Length prices vary across markets;
  - Comparability requires that the markets in which the independent and related companies operate do not have differences that have a material effect on price.

5. Business Strategies

- **What** is important?
  - Possible business may include among the others:
    - Innovation and new product development;
    - Degree of diversification;
    - Risk aversion;
    - Assessment of political changes;
    - Market penetration strategies.
- **Why** is it important?
  - Business strategies might have an impact on prices and comparability

Selection of the Tested party

The selection of the **tested party** shall be consistent with the functional analysis of the transaction

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"The tested party is the one to which a TP method can be applied in the most reliable manner and for which the most reliable comparables can be found"

(less complex party)

Identifying potentially comparable transactions

- **General remarks**:
  - A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction under examination;
  - Internal comparable: transaction between (i) a controlled party and (ii) an independent party;
  - External comparable: transaction between two independent parties;
  - Comparisons of a taxpayer's controlled transactions with other controlled transactions carried out by the same or another MNE group are **irrelevant** to the application of the arm's length principle and therefore should not be used by a tax administration as the basis for a transfer pricing adjustment or by a taxpayer to support its transfer pricing policy.

Identifying potentially comparable transactions

- **Internal comparables**:
  - Have a more direct and closer relationship to the transaction under review;
  - Financial analysis may be easier;
  - Where they exist they must comply with the 5 comparability criteria.
- **External comparables:**
  - Sourced in the external databases (commercial relying on publicly available information);
  - Use of commercial database should not encourage quantity over quality – research need to be properly refined;
  - Proprietary database developed and maintained by advisory firms – in this case Tax Authorities may ask to have access to the same database for transparency reasons.

Selecting or Rejecting potential comparable

- **Additive approach**:
  - Taxpayer draw up a list of third parties that are believed to carry out potentially comparable transactions;
  - Collections of information on those transactions in order to confirm whether they actually are acceptable comparables
  - Transactions retained in the analysis are carried out by well-known players in the taxpayer's market;
  - It may encompass internal and external comparables.
- **Deductive approach**:
  - The use of database is required;
  - It 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;
  - List is refined using selection criteria and publicly available information (e.g. from databases, Internet sites, information on known competitors of the taxpayer).

Comparability Adjustment

- **General remarks**:
  - Comparability adjustments are to be considered if (and only if) they are expected to increase the reliability of the results;
  - The need to perform numerous or substantial adjustments to key comparability factors may indicate that the third party transactions are in fact not sufficiently comparable;
  - Comparability adjustments need to be adequately documented.
- **Categories of Adjustments**:
  - Accounting adjustments (e.g., sales rebates may be recorded as negative sales or marketing expenses, R&D may be regarded as OPEX or cost of sales, resulting in a different gross margin);
  - Balance Sheet/Working Capital adjustments;
  - Other adjustments (risk, geographical location, economic crisis, contractual terms, group synergy etc.).

Selection of the most appropriate TP Methods

- The **selection of a transfer pricing method** always aims at finding the **most appropriate method** for a **particular case**;
- The **selection process** should take account of:

1. Respective **strengths** and **weaknesses** of each methods;
2. **Appropriateness** of the method in view of the **nature** of the **controlled transaction**, determined in particular through a functional analysis;
3. **Availability** of reasonably reliable **information** (in particular on uncontrolled comparables) to apply the selected method or other methods;
4. Degree of **comparability**, including reliability of any comparability adjustments needed.

Selection of the most appropriate TP Methods

- **Traditional transaction method** vs **transactional profit method**
  - Where a **traditional transaction method** and a t**ransactional profit method** can be applied in an **equally reliable manner**, the **traditional transaction method is preferable** to the transactional profit method;
- **CUP method** vs **other OECD methods**
  - Where, taking account of the criteria described at paragraph 2.2, the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred;
- **Methods not described in the TPG**
  - MNE groups retain the freedom to apply methods not described in these Guidelines (hereafter "other methods") to establish prices provided those prices satisfy the arm's length principle in accordance with these Guidelines;
  - Such other methods should however not be used in substitution for OECD-recognised methods where the latter are more appropriate to the facts and circumstances of the case.

The Arm’s length Range

- **General remarks**:
  - In some cases the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable;
  - If the range includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis;
- **Selecting the most appropriate point in the range**:
  - Where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm’s length principle;
  - If the relevant condition of the controlled transaction (e.g. price or margin) is within the arm’s length range, no adjustment should be made;
  - It may be appropriate to use measures of central tendency to determine the point of higher reliability ((for instance the median, the mean or weighted averages);
  - Where one or more of the potential comparables have extreme results, further examination would be needed to understand the reasons for such extreme results.