

# TRANSFER PRICING – COMPARABILITY ANALYSIS



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Comparability is the foundation of transfer pricing (TP). The arm's length principle builds on the comparability between a transaction controlled by two entities belonging to the same multinational group and a transaction between independent parties. Comparability also plays an important role in the selection of the most appropriate TP method.

## Steps to do comparability analysis

In order to apply the arm's length principle, it is necessary to undertake a comparability analysis. There are two steps involved:

1. An understanding of economically significant relevant characteristics of the controlled transaction; and
2. Comparison between the conditions of the controlled transactions and conditions in transactions between independent enterprises taking place in similar circumstances

Economically relevant characteristics can be referred to as comparability factors.



## Five comparability factors

### 1. Contractual terms

- a. These define how the risk and responsibilities are shared between the parties
- b. Starting point will be the written agreement but the actual conduct of the parties and other comparability factors also determine if the economic reality is consistent with the written contract
- c. Contractual terms will need to be carefully analyzed to see what rights and obligations are conferred on the parties e.g. if the terms mention exclusive rights of distribution, that would need to be factored in the pricing.

## 2. Functional analysis

- a. This is very significant in undertaking comparability analysis
- b. This involves the identification of functions, assets, and risks of a party to a transaction.
- c. Functions need to be analyzed such as – R&D, procurement, marketing & business development, production, back-office support, etc.
- d. Both tangible and intangible assets need to be identified
- e. Risk analysis plays an important role as the assumption of risk can influence the price

## 3. Characteristics of Property or Services

- a. Specific characteristics can account for differences in the value of property or services
- b. For example, in the case of the transfer of tangible goods, the physical features, quality, availability and volume of supply may impact the transaction value
- c. The variations in the characteristics may impact the transfer pricing method selected as the most appropriate

## 4. Economic circumstances

- a. This includes analysis of factors such as the state of the economy, degree of competition, the market position of the enterprise, etc.
- b. It is necessary to consider whether the third parties face the similar economic circumstance as the tested party, and if not, whether those differences are material



## 5. Business strategies

- a. The various strategies adopted by the business also play an important role in determining the arm's length price
- b. There are market share improvement strategies considered by multinational enterprises such as market penetration strategy, market expansion strategy or market maintenance strategy
- c. The allocation of the costs of these strategies between an MNE and its subsidiaries is an important matter in transfer pricing and will depend on the facts and circumstances of each case.

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