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Key Metrics in Transfer Pricing: The Role of Comparability

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Comparability Analysis

Why is Comparability Analysis required in Transfer Pricing?

Comparability analysis is crucial for ensuring the transactions between associated enterprises (controlled transactions) are priced fairly.

a) **Foundation of arm's length principle** - Comparability analysis helps determine whether the pricing of a controlled transaction aligns with what would be charged in an uncontrolled transaction/scenario.

b) **Understanding the characteristics of a transaction**- This provides an insight into the actual nature of transaction and the circumstances under which the transactions are entered into

c) **Identifying Reliable Comparables** – The understanding helps in selection of comparable companies/transactions that are similar to the controlled transaction.

d) **Substantiate Transfer pricing positions and minimize tax risks** - A well-documented comparability analysis strengthens the taxpayer's position during audits and helps mitigate tax risks.

When is a transaction considered as comparable?

- Transactions/Companies are considered comparable if any differences between them does not materially affect the margin/price that is being examined
- Reliable adjustments can be made to eliminate differences if the comparability is affected by such differences
- Comparability analysis is conducted using any one of the prescribed 6 methods

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Core Comparability Factors

What is required to be considered while undertaking comparability analysis?

To determine whether a controlled transaction is comparable to an uncontrolled one, the following factors must be evaluated:

- Characteristics of the Transaction – Determine the appropriate characteristics of the transaction i.e. in case of goods – physical characteristics, in case of services – nature of services and in case of intangibles – form, type and degree of legal protection (trademarks, patents, etc)
- Functions, Assets and Risks Analysis – forms the basis of comparability analysis – the ultimate goal is to compare the functions performed, assets utilized and risks assumed by the parties to the transaction vis-à-vis uncontrolled entities.
- Contractual Terms – Comparison must be based on the actual conduct/commercial substance of the controlled transaction over its legal/written contractual terms.
- Economic Circumstances - While undertaking comparability analysis, it is important to consider the market conditions and economic circumstances, including geographical location, market size, level of competition, and purchasing power.
- Business Strategies – In-depth understanding of the overall business strategies of the Group and the entity under consideration is required – e.g. whether any specific business strategy is adopted by the entity like market penetration strategy that might have an impact on the profits.

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Economic Adjustments

Factors to be considering while undertaking comparability analysis

- ✓ The Income Tax Rules provide that reasonably accurate adjustments can be made to eliminate the differences, if such factors have an impact on the profitability or price of the transactions that is being compared.

- ✓ While the law generally favors applying economic adjustments to the comparables, several judicial pronouncements have validated adjustments made to the tested party. Accordingly, based on the specific facts and circumstances of each case, economic adjustments may be undertaken either on the tested party or on the comparables.

- ✓ When all companies in the industry operate under similar conditions, specific economic adjustments may not be necessary.

- ✓ Since the tax regulations do not prescribe a specific method for computing economic adjustments, it is essential to understand the underlying business objectives of each pricing strategy before determining the appropriate approach to such adjustments.

- ✓ In certain cases, the absence of reliable comparable data may hinder the ability to perform meaningful economic adjustments. Therefore, it is crucial to utilize publicly available data to the extent possible, in order to support the analysis and mitigate potential litigation risks.

- ✓ Wherever feasible, economic adjustments should be quantified during preparation of TP documentation, as this positions the company more favorably during transfer pricing audits.

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Situations that warrant economic adjustments

Capacity Utilization Adjustment

This adjustment is undertaken during the initial stage of business or when the company has unutilised capacity owing to various reasons including business expansion. In the recent times, since there is paucity of capacity information, alternative approaches such as industry capacity, depreciation / fixed cost based adjustment can be adopted.

Customs Duty Adjustment

When a company incurs significantly high customs duty cost owing to import of goods as compared to comparable companies who source it domestically, customs duty adjustment might be considered.

Working Capital Adjustment

In case there are differences in the working capital of the tested party vis-à-vis comparable companies which has the potential to impact the profitability, working capital adjustment might be undertaken.

Market Risk Adjustment

This adjustment aims to quantify the risk differential between the taxpayer (contract service provider) and comparable companies (entrepreneurial entities)

Forex Adjustment

This adjustment is undertaken to eliminate the impact of adverse forex fluctuation embedded in the price of a product/service

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How VSTN can help?

- Experience of preparing documentation for more than 17 countries across the globe Access to all major global databases like Moody's Orbis- TP catalyst, Moody's -EDFX , ktMINE, Thomson Reuters Onesource, Royaltyrange, Prowess
- Highly experienced professionals with culminative TP experience of 100+ years
- The core team has expertise in dealing with TP audits on various issues before multiple forums up to the level of High Court who can hand-hold to prepare a fool-proof transfer pricing document.
- Awarded as the Best Newcomer in Asia Pacific – 2024 by International Tax Review (ITR)
- Recognized as one of the finest performing transfer pricing firms by ITR

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ABOUT US

- VSTN Consultancy is a Global Transfer Pricing firm with extensive expertise in the field of international taxation and transfer pricing having its offices in India and UAE. VSTN Consultancy has been awarded by International Tax Review (ITR) as Best Newcomer in Asia Pacific – 2024 and is recognized as one of the finest performing transfer pricing firms. VSTN Consultancy has been shortlisted in 9 awards as finalist by ITR for Tax Innovator, Tax Compliance and Reporting Firm, Transfer Pricing Leader , Transfer Pricing Rising Star in Asia Pacific – 2025 | Best Newcomer, Tax Innovator and Transfer Pricing Leader in EMEA – 2025 | Best Newcomer and Transfer Pricing Leader in the Middle East – 2025.
- Our offering spans the end-to-end Transfer Pricing value chain, including design of intercompany policy, drafting of Interco agreement, ensuring effective implementation of the Transfer Pricing policy, year-end documentation and certification, Global Transfer Pricing Documentation, BEPS related compliances (including advisory, Masterfile, Country by Country report), safe harbor filing, audit defense before all forums and dispute prevention mechanisms such as Advance Pricing agreement.
- We are structured as an inverse pyramid where leadership get involved in all client matters, enabling clients to receive the highest quality of service.
- Being a specialized firm, we offer advice that is independent of an audit practice and deliver it with an uncompromising integrity.
- Our expert team brings in cumulative experience of over several decades in the transfer pricing space having worked with multiple Multinational Companies across sectors/industries and have cutting edge knowledge and capabilities in handling complex TP engagements.

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