



## Comparability Analysis in Transfer Pricing: Problem and Guideline in Selecting the Most Appropriate Method

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**ABSTRACT:** Transfer pricing in business is a common practice, especially for multinational companies (MNE). This practice is encouraged by the main objective of an entity: maximizing profit. A group of entities will make transactions in the group that can provide maximum profit for them. Transfer pricing practice becomes illegal when it is used for tax avoidance purposes. One of the important factors in transfer pricing analysis is the determination of the appropriate method. Determination of the method is important because with this method a MNE will determine what is the arm's length price or profit of a transaction. In determining the appropriate transfer pricing method, one of the things that must be done first is to identify the availability of comparability in the form of price or profit data.

**KEYWORD:** Transfer Pricing, Comparability, Taxation, Transfer Pricing Method

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### I. INTRODUCTION

The era of globalization encourages multinational companies (MNE) to operate in several countries that have different tax rates and regulations. There is a risk for tax administration in each country regarding the possibility of tax avoidance efforts through transfer pricing schemes that occur between multinational companies that are members of a business group domiciled in different countries.

The importance of international transfer pricing (ITP) has increased alongside the globalization of business and the increasing importance of international trade and global marketing. During the 1990s and early 2000s, the OECD (Organization for Economic Co-Operation and Development) and numerous different countries have published a series of transfer pricing guidelines, rules, and regulations. These developments have raised the profile of ITP and increased the pressures placed on MNE to ensure that their intra-group transactions reflect arm's length price. Transfer pricing refers to the pricing policies and practices that are established when physical goods, intangible property, and services are charged between business units within a group. The prices which are established for cross-border transfers should satisfy the "arm's length principle". Essentially, this principle requires that intra-group transfer prices should be equivalent to those that are/would have been charged between independent persons dealing at arm's length in otherwise similar circumstances [1].

A transfer price is set and used by MNCs to quantify the goods and services transferred from one subsidiary in a specific country to another subsidiary in another country. As MNCs expand and transfer products and services overseas, the issue of transfer pricing on an international basis has become a critical tool to achieve certain objectives. The objectives can be categorized as internal and external. The internal objectives include facilitating performance evaluation between managers in foreign subsidiaries. The external objectives include reduction of global income taxes; tariffs; minimization of foreign exchange risk; avoidance of any conflict with host countries' governments; management of cash flows; and increasing competitiveness in the global markets [2].

Transfer pricing analysis is conducted to compare controlled transactions with uncontrolled transactions. Controlled transactions refer to affiliated transactions. In an affiliated transaction, the parties have the same interest, namely maximizing the potential aggregate profit. Therefore, transactions carried out in affiliated relationships are indicated to have control to achieve the desired results. This is different from independent transactions where transactions occur based on the strength of supply and demand (market mechanism) as well as economic factors in general. Independent transactions are not influenced by group interests so that the agreements that arise are the impact of actual market conditions. Therefore, transfer pricing analysis focuses on the comparability between the two transactions in order to determine the arm's length principle.

## **II. RESEARCH METHODOLOGY**

This study uses qualitative research, which is a research paradigm that emphasizes the understanding of problems in social life based on reality conditions or natural settings that are holistic, complex and detailed [3]. Meanwhile, the approach used is a case study, in this case the analysis and observation of the best possible transfer pricing comparability cases that occur in the realm of global challenges in order to obtain objective results and conclusions. The research data used is secondary, namely data that is not obtained from the main source, but through collecting and reviewing data from the sources obtained so that research becomes the second party to manage and critique the data obtained [4].

Furthermore, these data are collected and documented based on their relationship to research studies obtained from online literature from the internet. Thus, the analysis technique uses data reduction in the form of collecting, summarizing, selecting the main things related to the research topic, display data, presenting data in accordance with certain forms relevant to research and describing briefly the relationship of each category, and verification or withdrawal. Conclusions, both provisional conclusions and final conclusions after obtaining strong evidence that supports the final conclusion.

## **III. THEORETICAL REVIEW**

The transfer pricing study essentially seeks to assess whether the transaction being analyzed has met the arm's length principle. The application of the arm's length principle originates from the comparison between two objects, namely affiliated transactions and independent transactions. Therefore, the two objects, comparative analysis of affiliated transactions with independent transactions (comparability analysis), constitute the "soul" of the arm's length principle (Irawan, Febby, & Kristiaji, 2013).

The comparability analysis uses a comprehensive analysis to compare transaction in establishing the arm's-length price. A transaction is evaluated by comparing the result of controlled transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. All factors that "could affect prices or profits" must be included in comparability analysis. Five factors are enumerated in the regulations: 1) functional analysis, 2) contractual term, 3) risk, 4) economic condition, 5) property or service [5].

The OECD has defined nine stages in carrying out a comparability analysis. The OECD considers this stage to be the best technical guidance that can be received, although it is not compulsory. This relates to any other process leading to the identification of reliable comparables may be acceptable as reliability of the outcome is more important than the process (OECD, 2017). Here are nine steps in the OECD's suggested comparability analysis:

### **Step 1 - Determination of years to be covered**

Determining the analysis period is an early and important stage in comparability analysis. If the analyzed transaction period is 2020, then a comparison search is made when the affiliate transaction is carried out. This is an effort to fulfill the principle of comparability and also the principle of contemporaneous document where transfer pricing analysis is carried out based on and information available at the time the affiliate transaction is conducted.

### **Step 2 - Broad-based analysis of the taxpayer's circumstances**

Comprehensive analysis of the condition of the taxpayer is an important stage in the comparability analysis. This stage is carried out by analyzing the industry being run, how the level of competition, economic and regulatory factors, and other factors that can affect taxpayers.

### **Step 3 - Understanding the Controlled Transaction(s)**

At this stage, the affiliated transactions are identified which are analyzed, such as: the type and value of the transaction, the background of the transaction, the terms of the contract, etc. This is carried out in order to find the tested party, the most appropriate method, financial indicators (in transactional profit method), and to identify significant factors in the comparability that must be considered.

### **Step 4 – Review of Existing Internal Comparables, if any**

Internal comparables (transactions carried out between the taxpayer with the tested party and independent parties) need to be examined carefully in each method used. Taxpayers may face the possibility of using internal comparable, both at the price level and operating profit.

### **Step 5 – Review information of external comparable**

If an internal comparable is not available or not reliable, an external comparable may be used. In this step, efforts were conducted to find potential external comparable as reliable comparable.

### **Step 6 – Selection of the most appropriate transfer pricing method**

Selection of transfer pricing method is determined based on comparability factors that have been made and the type of affiliated transactions being analyzed.

### **Step 7 – Identification of Potential Comparables**

Determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors set forth at Section D.1 of Chapter I (see OECD, 2017). Five factors are enumerated in the regulations: 1) functional analysis, 2) contractual term, 3) risk, 4) economic condition, 5) property or service [5].

### **Step 8 – Make comparability adjustments if necessary**

In case that the available potential comparable differ from the transactions being analyzed, adjustments for those differences must be made.

### **Step 9 – Interpretation and usage of data that has been collected, and determination of arm's length aspects**

This last step is taken in order to calculate an arm's length price or profit level indicator using a reliable comparable.

In practice, this process is not a linear one. Steps 5 to 7 in particular might need to be carried out repeatedly until a satisfactory conclusion is reached, i.e. the most appropriate method is selected, especially because the examination of available sources of information may in some instances influence the selection of the transfer pricing method. The comparability factor at stage 7 becomes the main issue in this research.

A reliable transfer pricing analysis aims to obtain a high degree of comparability between affiliated transactions and independent transactions. In determining the appropriate degree of comparability and adjustment, parameters are needed to compare factors that might influence the comparability between the analyzed transactions and the independent transactions. According to Cooper, Fox, Loeprick, and Mohindra in the book *Transfer Pricing and Developing Economies: A Handbook for Policy Makers and Practitioners* (Cooper, Fox, Loeprick, & Mohindra, 2016), these parameters refer to the following five comparability factors:

#### **1. Contractual Term**

Contractual agreements are commonly the starting point for delineating a transaction, but may be supplemented (or replaced) by information on the actual conduct of related entities in their commercial or financial relation (actual function performed, assets used, risks assumed, etc.) The contractual of a transaction will influence the allocation of function and risk between independent parties and, therefore, the price charged and margin earned. Accordingly, differences in contractual terms applicable to the controlled transaction and uncontrolled transaction require identification and analysis. Examples of contractual terms that may influence the price or margin may include but not limited to:

- Differences in volumes
- Differences in payment terms (e.g., net 30 days as compared to net 90 days)
- Shipping terms (e.g., “free on board” [FOB] as compared to “cost, freight” [CFR] and “cost, freight, insurance” [CIF])
- Geographic area, exclusivity, and duration in relation to the licensing of intangibles
- Currency, security, and call and repayment option in relation to financial transaction.

#### **2. Functional Analysis**

Compensation in transactions between independent parties will usually reflect the function that each party to the transaction performs, the assets it employs, and the risks it assumes. For example, the more functions a party performs, the greater risks it bears; the higher the value of the assets it employs in relation to a transaction, the greater the remuneration it would expect to receive from the other party, as a result, the remuneration of a party, and therefore its profit potential, with respect to a transaction or set of transactions will generally be correlated with the functions it performs, the risks it bears, and the assets that it employs.

#### **3. Characteristics of the Property or Service**

The specific characteristics of a product or service that is the object of transaction will impact upon the value attributed to that product or service by the parties to the transaction. Therefore, when assessing the comparability of the transactions, it is important to consider the characteristics of the products or services in transaction being compared.

Differences in characteristics of the property or services may or may not materially impact comparability since different weighting may need to be attached to the characteristics of the goods and or

services in relation to other comparability factors depending on the transfer pricing method being applied, and thus the condition being examined. For Example, differences in the characteristics of the product or services are more likely to have material impact on the price and are, therefore, of importance when applying the comparable uncontrolled price (CUP) method. However, such differences may be less likely to have material impact on gross or net profit margins and, therefore, may not materially affect comparability for the purposes of applying the cost-plus method, resale price method, or transactional net margin method (TNMM). It does not follow, however that differences in the characteristics of the product or service can simply be ignored when applying method that examine gross or net profit margins. Differences in the characteristics of the product or services may, for example, have broader implications particularly in relation to determining the economically significant function, assets, and risks of the parties, and understanding the economic circumstances and business strategies.

#### **4. Economic Circumstances**

Information regarding the relevant characteristics of the industry and market in which the controlled transaction takes place is generally obtained in an industry analysis. Relevant factors that may require further consideration in relation to potentially comparable uncontrolled transaction (so as to identify whether they materially impact the condition being examined) include:

- Geographic location
- Market Size
- Barriers to entry
- Level of the market (wholesale, retail, etc.)
- Competition
- Existance and availability of substitutes
- Location-specific costs
- Government regulation
- Economic condition of the industry
- Consumer purchasing power
- Economic, business, or product cycles

#### **5. Business Strategies**

Adoption of particular business strategies may have an impact on the pricing of products or groups of products over their life cycle. Such strategies may include, inter alia, market penetration, market expansion, market maintenance, and diversification strategies depending on the facts and circumstances.

A market penetration or expansion strategy may require that products are sold at a reduced price into the market at the outset in anticipation of future profit, or certain products may be sold at cost or a loss to develop or maintain a market for related products (e.g., razors and razor blades, printers and ink cartridges, or coffee machines and coffee capsules).

Consideration of business strategies pertaining to the controlled transactions and any potentially comparable uncontrolled transactions therefore require identification and analysis since they may have a material impact on the condition being examined (i.e., it would most likely not be appropriate to compare a transaction involving the sale of an established product to an established market participant with the sale of a new product to a new venture undertaking a market penetration strategy).

### **IV. RESULT AND DISCUSSION**

The transfer pricing study essentially seeks to assess whether the transaction being analyzed has met the arm's length principle. The application of the arm's length principle originates from the comparison between two objects, namely affiliated transactions and independent transactions. Therefore, comparative analysis of affiliated transactions with independent transactions (comparability analysis), becomes the "soul" of the arm's length principle (Irawan, Febby, & Kristiaji, 2013). In an effort to gain reliable transfer pricing conclusions, comparative analysis needs to be used as an initial benchmark in determining reliable methods. The following is an explanation of the relationship between comparability analysis and the transfer pricing method used and the problems faced in the comparability analysis:

#### **Comparable Uncontrolled Price Method (CUPM)**

CUPM is comparing the prices of tangible and intangible goods and services that are transacted between affiliated transactions and independent transactions. CUPM is the most sensitive method to differences in comparability factors. In using CUPM, independent transactions are stated to be comparable to transactions being analyzed if: 1) there are no differences in the transactions being compared that might affect prices, or, 2) accurate adjustments can be made to eliminate differences in the transactions being compared (United Nations, 2017). The comparability level required to use the CUPM method is described in Table 1 below:

*Table 1 Comparability Factors Required in Using the CUP Method*

No	Comparability Factors	Level of Comparability Required
1	Products or services being transacted	High
2	Functional analysis	Moderate
3	Terms and conditions in the contract	High
4	Business strategy	High
5	Economic situation	High

CUPM does not allow any differences in comparability between affiliated transactions and independent transactions. Any differences that appear in the comparability factors that affect the price, it is necessary to make adjustments to these differences. An example of an adjustment that may be made in a CUPM is when there are differences in the terms of the contract where transactions to affiliates use the shipping term FOB while independent transactions apply CIF. Therefore, for transactions to independent parties, adjustments need to be made as if the shipping terms used the FOB value. Adjustments cannot be made to CUPM when the differences arising from the product being transacted are different. Because the CUPM compares at the price level, the product differences are very significant and no adjustment is possible. In the event of such discrepancies, another transfer pricing approach can still be used, either comparing the gross profit level or the operating net profit.

The implementation of CUPM is an effort to search for arm's length results with the maximum effort because it has to find a comparison of the five existing factors. However, the results of the CUPM analysis can be considered to have the highest accuracy among the five methods provided. Due to this difficulty level, CUPM has a major problem that is often faced, namely the availability of comparative data. Generally, internal comparative data is used to perform CUPM analysis, however, in the case of a product being transacted is a commodity product, the use of an external comparator can be used. External comparisons related to commodity products can be in the form of reference prices that can be accessed by the public.

#### **Resale Price Method (RPM)**

RPM analyzes by comparing the resale price of products to independent parties for purchases from affiliates. The resale margin will be compared with similar transactions to see whether the purchases made to affiliates have determined the same margin as the margin obtained from independent transactions. Determination of the appropriate level of profit indication at the gross margin level must be based on the functions and risks that are carried out. Because the determination of arm's length on the RPM uses the gross profit benchmark, the RPM does not require high comparability on the similarity of the transacted product. Table 2 shows the comparability level required in RPM.

*Table 2 Comparability Factors Required in Using the RPM*

No	Comparability Factors	Level of Comparability Required
1	Products or services being transacted	Moderate
2	Functional analysis	High
3	Terms and conditions in the contract	High
4	Business strategy	Moderate
5	Economic situation	Moderate

RPM does not require a price level comparison. The difference on the product does not have a significant effect on the arm's length results. RPM can be used when: 1) there are no material differences (e.g. contract terms, shipping terms, etc.) between the transactions being analyzed and 2) accurate adjustments can be made to eliminate differences in the transactions being compared (United Nations, 2017). Based on these provisions, RPM emphasizes more on the functions that are carried out, not on transactions. So that functional comparability is needed more than product comparability. Functional comparability and comparability of contract terms are required over product comparability. Meanwhile, the factors of business strategy and economic situation are generally influenced by the provisions of the applicable contract and the functions performed. As an example of its application, a blender distributor may be compared with other similar transactions even though the transacted products are not identical. For example, there is an iron distribution transaction that performs the same function (for example, marketing and takes inventory risk), then the two transactions can be compared. RPM can be implemented using an internal comparator or an external comparator. So that its application is easier and can be generalized without looking at the comparability of the product (can be applied simultaneously based on product groups that perform the same function).

RPM has a fairly high degree of comparability under CUPM. However, there are issues in the



application of RPM where accounting practice is another factor that determines comparability. For example, recording an affiliate transaction may differ from an independent transaction such as recording discounts, transportation, and product warranties where an affiliate transaction may record it in the cost of goods sold item while an independent transaction is recorded under operating expenses. Differences in inventory valuation can also affect comparability where these differences are difficult to adjust.

### **Cost Plus Method (CPM)**

CPM is used by comparing the incremental margin on costs that appear on affiliated and independent transactions. This additional margin will later be compared as a measure of arm's length principle by considering the functions performed, the risks borne, and the assets used. CPM is generally used by manufacturing, assembly, and service companies. Determination of the appropriate level of profit indication at the gross margin level must be based on the functions and risks that are carried out. Since the determination of arm's length on the CPM uses the gross profit benchmark, CPM does not require high comparability on the similarity of the products being transacted. Table 3 shows the comparability levels required in CPM.

*Table 2 Comparability Factors Required in Using the CPM*

No	Comparability Factors	Level of Comparability Required
1	Products or services being transacted	Moderate
2	Functional analysis	High
3	Terms and conditions in the contract	High
4	Business strategy	Moderate
5	Economic situation	Moderate

Similar to RPM, CPM does not require a price level comparison. The difference on the product does not have a significant effect on the arm's length results. CPM can be used when: 1) there are no material differences (eg contract terms, shipping terms, etc.) between the transactions being analyzed and 2) accurate adjustments can be made to eliminate differences in the transactions being compared (United Nations, 2017). Based on these provisions, CPM emphasizes more on the functions carried out, not on transactions. Functional comparability and comparability of contract terms are required over product comparability. Meanwhile, the business strategy and economic situation are generally influenced by the provisions of the applicable contract and the functions performed.

CPM has a fairly high degree of comparability under CUPM and is equivalent to RPM. However, there are issues in the application of RPM where accounting practice is another factor that determines comparability. For example, recording an affiliate transaction may differ from an independent transaction such as recording Research and Development (R&D) expenses where an affiliate transaction may record it in the cost of goods sold item while an independent transaction is recorded in an operating expense account. In addition, it is possible that the costs incurred in the transaction have a weak association with market prices. This can be seen from the amount of gross profit value and varies each year.

### **Profit Split Method (PSM)**

According to Cooper, Fox, Leoprick and Mohindra [6] the profit split method begins with the combined profit (or loss) arising from the controlled transactions and then attempts to split the profits between the associated enterprises party to those transactions on an economically valid basis. Where possible, this economically valid basis should be supported by market data. However this is not always possible and thus internal data, applied objectively using, for example, allocation keys, may need to be replied upon.

The application of the PSM is an important building block to implement the arm's length principle and align profits with value creation in situations where the scope for application of other methods is limited due to the features of transaction. When applying the PSM, different approaches may be use for ddetermining the appropriate (arm's length) split of profits between the parties:

- Contribution analysis: combined profits from the controlled transactions allocated between the associated parties on the basis of their relative contributions
- Comparable profit split: combined profit (or loss) is split by reference to comparable split between indepent enterprises
- Residual analysis: two-step approach that first allocates profits to nonunique (routine) activities and then splits the residual profit on economically valid basis.

In the profit split method, the comparability of the product and the terms of the contract no longer has a significant effect on the results of the analysis. PSM emphasizes comparability in the analysis of functions, assets and risks to identify the allocation of profit sharing among its affiliates. The allocation and weighting of

values for the analysis of functions, assets and risks are crucial points in the application of the PSM analysis. It can be considered that other comparability factors such as business strategy and economic situation do not have a material impact on the results of the analysis. Table 4 shows the level of comparability required in PSM.

*Table 3 Comparability Factors Required in Using the PSM*

No	Comparability Factors	Level of Comparability Required
1	Products or services being transacted	Low
2	Functional analysis	High
3	Terms and conditions in the contract	Low
4	Business strategy	Moderate
5	Economic situation	Moderate

PSM is usually used for transactions that are so closely related that they are difficult to evaluate separately. Although PSM has a low level of comparability, this method can be the answer when other available methods cannot be used, for example because affiliate transactions involve unique intangible assets.

### **Transactional Net Margin Method (TNMM)**

TNMM compares the operating net income obtained from transactions with affiliated parties with the operating net income obtained from transactions with independent parties (internal). TNMM can also be applied as a whole (company-wide) by comparing the net income obtained from affiliates with comparable companies. Because TNMM uses operating net income as a measure of arm's length TNMM can be said as an indirect method because it is not directly related to the transaction. The accuracy of TNMM is below CPM and RPM, and even far below CUPM. However, the use of TNMM is less affected by transactional differences compared to prices as used in the CUP method and is more tolerant of functional differences between affiliated transactions and independent transactions which are often reflected in various operating costs, so that analysis of net profit indicators yields better reliability compared to gross profit margin. Table 5 describes the comparability factors required in using TNMM.

*Table 4 Comparability Factors Required in Using the TNMM*

No	Comparability Factors	Level of Comparability Required
1	Products or services being transacted	Low
2	Functional analysis	High
3	Terms and conditions in the contract	Low
4	Business strategy	Low
5	Economic situation	Moderate

TNMM emphasizes the use of function, asset, and risk comparability analysis for the search for reliable comparable. For example, because direct transactional comparisons cannot be made, TNMM compares net operating income as an profit level indicator (PLI). This PLI will later be compared comparable companies that run business in the same field and perform the same functions, assets and risks as the taxpayer. Product similarity is not the main point in looking for comparable companies, neither are the terms of the contract, business strategy and the economic situation.

## **V. CONCLUSION**

Transfer pricing analysis is essentially conducted by comparing the price and profit margin of affiliated transactions with independent transactions. Analysis using such a comparative approach should focus on certain factors as parameters for achieving comparability. Therefore, in an effort to carry out a transfer pricing analysis using available methods, a comparative analysis is required. In this analysis, the researchers agree that comparability plays an important role as an initial stage in conducting transfer pricing analysis. Table 6 shows a summary of the relationship between the comparability analysis and the methods used in transfer pricing analysis and measures the level of difficulty in its application.

*Table 6 Summary of methods used in transfer pricing analysis, comparability analysis and level of difficulty in its application*

No	Transfer Pricing Method	Prioritized Comparability Factor	Level of Comparability	Level of difficulty in its application
1	CUPM	Similarity of Products and Services	Tinggi High	High
2	RPM	Functions performed	Moderate	Moderate

*Table 6 Summary of methods used in transfer pricing analysis, comparability analysis and level of difficulty in its application*

No	Transfer Pricing Method	Prioritized Comparability Factor	Level of Comparability	Level of difficulty in its application
3	CPM	Functions performed	Moderate	Moderate
4	PSM	Functions performed and Economic Conditions	Low	Low
5	TNMM	Functions performed and Economic Conditions	Low	Low

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