

# Benchmarking: The Heart of the Arm's Length Process



The arm's length principle—the cornerstone of transfer pricing regulations—requires that prices and conditions applied in controlled transactions between related parties be consistent with those that would exist in similar transactions between independent, unrelated parties in a free-market setting.

But how exactly do you find (and support) that elusive arm's length price? Enter the benchmarking analysis—a set of comparable observations that can help assess whether the prices used in your related-party transactions fall within an acceptable range.

It sounds straightforward, but it's a little trickier in practice. In this article, we dive into the details.

## Why Benchmarking is Important

First, the most obvious reason why you should conduct a benchmarking analysis: It's required by law.

Most countries mandate that multinational enterprises (MNEs) must perform a benchmarking analysis to support the arm's length nature of their intercompany transactions and incorporate the details of that analysis in their documentation. And since each country has its own regulatory quirks and individual rules, that compliance burden is multiplied by as many jurisdictions as you operate in—enough to keep an army of tax experts busy.

Should an issue arise with a tax authority, having a solid benchmarking analysis to support pricing decisions can only strengthen the company's position during discussions. More generally, having a robust and defensible pricing structure for all intercompany transactions can help build long-term trust with tax authorities—meaning a reduced risk of transfer pricing adjustments, penalties, and disputes.

But the benefits of benchmarking don't end with compliance and preparedness for potential inquiries. Consider all the value that an in-the-weeds study of comparable companies' financial data and activities can offer.



A well-run benchmarking analysis enables MNEs to assess their performance relative to industry peers, understand market trends, and make informed decisions about expansion, investment, and resource allocation. It can identify potential cost-saving opportunities and help optimize internal pricing strategies. There's also the transparency factor: benchmarking provides robust data to support financial reporting, which can only enhance stakeholder confidence and investor trust—especially for companies operating in multiple tax jurisdictions.

## How to Conduct an Effective Benchmarking Analysis

Benchmarking, as noted, is the process of identifying comparable observations that support the arm's length nature of intercompany transactions. It involves finding companies or agreements with similar functions, risks, and assets, which can serve as a basis for determining an appropriate transfer price between your related parties. Given the real-world, empirical data required, this is not going to be a neat, cut-and-dried process: it takes subjectivity and judgment calls, awareness of your risk appetite, and plenty of statistical adjustments to make those comparisons.

While there are several transfer pricing methods available, this article is focused on a profit-based analysis. Here are the basic steps:

**Identify the controlled transactions.** Define the specific intercompany transactions whose transfer pricing positions need to be analyzed. These transactions can include buying and selling goods, providing services, or licensing intangible assets.

**Select the tested party and analyze it.** In a profit-based analysis, the “tested party” of your intercompany transaction would typically be the subsidiary or division directly tied to recorded profits. Start with a good understanding of the functions and economic circumstances of that tested party. Be sure to drill down into the actual intercompany agreements to nail down the relevant details—often, the functions described there don't neatly conform to reality. Gather financial data: consider what assets the tested party holds, what kinds of risks it assumes, how profitable it is. This functional analysis will form the bedrock of your transfer pricing documentation.




**Decide on your search strategy.** With that foundational understanding of your tested party in hand, you're ready to look for external companies with a roughly similar set of functions, assets, and risks who may have comparable transactions you could use as benchmarks. While traditionally, comparables were sought within the same industry, in this era of data availability and AI, that is no longer essential. In a profit-based analysis, what really matters is that results are based on the functions being performed, comparable levels of risks taken, and the assets employed.

**Choose the right database to hunt for the best comparables.** Now it's time to go searching for the best comparables you can find. There are a wide variety of databases available—everything from public databases like S&P Global's to private, specialized ones like Royaltystat. While tax authorities may prefer a local database, there's no regulation mandating the use of a specific database. (Remember, all public company data is publicly available, and most private company data is widely available from public registries and credit rating agencies.) What really matters is that the data be reliable and sufficient enough to create a benchmarking study.

**Jurisdictional considerations: local or regional?** While it's important to be sensitive to the preferences of local tax authorities and seek out comparables within the same country as your tested party, it's often necessary to widen your search aperture to include regional companies. (More relevant, comparable data might be found, for instance, across all of Europe rather than in Portugal alone.) That said, it's essential to be aware of the panoply of country-specific transfer pricing rules which companies are required to observe—issues like whether startups are allowable for comparables, or differing loss criteria, or corporate structuring. There are as many versions as there are countries.

**Apples to apples? Make the necessary adjustments.** It's exceedingly rare to find slam-dunk data that perfectly fits your tested-party transaction. So, you'll likely need to make adjustments—typically working-capital adjustments—to get as close to an apples-to-apples comparison as possible. This would generally involve adjusting and standardizing balance-sheet items like inventory, accounts receivable or payable to the tested party, to get a more reliable profitability outcome. Other adjustments could be needed to account for business practices, accounting standards, product quality, or contract terms.



**Calculate the arm's length range.** Once you've gotten a basket of comparable observations, it's time to calculate the real-world, arm's length range of acceptable profit margins. Using the profit margins of the comparable companies, you'll apply a statistical analysis to establish the range of prices that would be charged between unrelated parties for transactions similar to yours, taking into account the profitability of the tested party. If your intercompany pricing falls within that acceptable range, it's considered at arm's length. If it falls outside that range, you may need to make adjustments to your transfer prices or profit allocations to bring them in line with what unrelated companies would do.

**Document, document, document.** You can never be sure of (let alone, control) how tax authorities will respond to your transfer pricing positions—so it's always wise to be prepared for any potential audits or inquiries. Thoroughly document all the steps taken, data collected, adjustments made, and the rationale behind the choices you've made (including the transfer pricing methodology) to support your benchmarking analysis. The more comprehensive your documentation, the more defensible your position will likely be.

## Necessary questions to consider

As you proceed through your benchmarking analysis, many procedural questions will pop up. Here are some of the key ones you'll need to address:

**Single-year analysis or multiyear?** When it comes to comparing profitability of potential comparables versus the tested party, most tax authorities prefer a multiyear analysis—typically a weighted average of three to five years of data—to help smooth out the effect of cyclicity and get a better measure of the company's business decisions and their impact on its overall operating framework.

**Interquartile or full range?** There are two basic statistical techniques used for calculating the real-world, arm's length range of acceptable profit margins: the interquartile range (IQR) and the full range. The choice of which to employ is sometimes dictated by the relevant tax authority.

The IQR method focuses on the middle 50% of the data points in the dataset, excluding outliers and extreme data points, to arrive at a stable, conservative measure of the range. It's often favored for its ability to provide a more reliable and defensible analysis, especially in cases where tax authorities prioritize a conservative approach.

The full range, on the other hand, includes all data points in the dataset, without excluding outliers. It provides a broader perspective of the data distribution, incorporating extreme values that may reflect actual market conditions—and allowing for greater flexibility and a more inclusive approach to the analysis. This could benefit companies with a higher risk tolerance, who seek to support their transfer pricing positions with a broader range of comparables, or where the benchmarking study lacks sufficient data points to calculate a reliable IQR.

**Roll-forward or every year?** How (and how often) should your company reevaluate its transfer pricing positions? Some will simply roll forward the previously identified comparable data and update it with the most recent financial information, reducing the need for full searches every year. This not only provides consistency in benchmarking, it's also more cost-effective. The potential downside is that this may not capture changing market dynamics, especially over multiple years.

Other companies will conduct a fresh benchmarking search annually, performing a new search for comparable data each year. This ensures that the most current and relevant data is used in the analysis. It also has the extra benefit of providing up-to-date market data, reflecting the latest economic conditions and industry trends. This approach may be preferred in fast-changing industries where market conditions can significantly impact transfer pricing outcomes. The downside is that this can be a resource-hogging activity. Also, as it may result in variations in the comparables from year to year, it could introduce complexity in tracking changes and explaining differences to tax authorities.

Some companies will seek out a Goldilocks solution—a combination of both methods to strike a balance between compliance, accuracy, and efficiency in transfer pricing documentation.



**How to average out the comparable data points?** There are three approaches available: the simple average, the weighted average, and the period-weighted average. Each has its advantages and use cases in the context of arriving at an appropriate arm's length range for intercompany transactions. The *simple average* treats all data points equally. Since it's based on the assumption that there are no significant differences in the functions, assets, and risks among the comparables, its usefulness is limited to situations where the selected comparable companies have relatively equal importance in the overall analysis.

When there are variations in the size or significance of the comparable companies being analyzed, the *weighted average*—which assigns higher weights to the most relevant comparables—produces a more accurate and tailored benchmark that more reliably reflects the tested party's specific characteristics, which tends to be the preference of many tax authorities. The *period-weighted average* is useful when market dynamics are rapidly changing or when there are significant fluctuations in financial performance over time. By emphasizing recent years, this method ensures that the benchmark is reflective of the current economic landscape, especially critical in fast-paced industries.

## Conclusion

Benchmarking is a vital, complex process that's both art and science. It requires a deep understanding of transfer pricing regulations, statistical skills, prevailing market conditions, and the economic realities of all the parties and transactions involved. It also requires significant analytical rigor.

But even with a well-conducted benchmarking study, there's always a risk that tax authorities might challenge or adjust your transfer prices. All the more reason why your benchmarking analysis should be conducted with meticulous care—and robust, accurate, and objective.

When you consider how benchmarking can also help you gain insights into market conditions, industry trends, and your competitors' performance—and thus enhance your own strategic decision-making and business planning—it's easy to see why there is no downside to doing it right.

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