

## PRACTICAL APPROACH REGARDING THE BENCHMARK STUDY IN THE CONTEXT OF A TRANSFER PRICING ANALYSIS

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### **Abstract**

*Transfer pricing subject approached from the perspective of the transfer pricing analysis is relatively a new concept studied within the literature. The process of such an analysis involves the going through several stages, including the performance of a benchmark study (i.e. a study which provides information in relation to the prices/profitability indicators obtained by independent entities performing similar transactions to that under analysis). The benchmark study is very important in the context of a transfer pricing analysis as based on its results there could be assessed if a related-party transaction complies or not with the arm's length principle (i.e. if the prices charged within the related-party transaction are at market level). In this context, the objective of the paper is to illustrate based on a case study how should be performed a benchmark study for a related-party transaction which involves the provisions of IT services. In this respect there was used the online version of the Orbis database and the search criteria applied were correlated with the applicable provisions of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (version published in 2017). The main conclusion of the paper is that transfer prices are not an exact science and the benchmark study presented within this paper should not be understood as a universal recipe, but rather as an example based on which the readers could familiarize with the mechanism involved by a benchmark study.*

**Keywords:** benchmark study, comparability analysis, transfer pricing, OECD Transfer Pricing Guidelines

**JEL classification:** K34, M40

### **1. Introduction**

In the interwar period, more exactly in a short time after the First World War, tax rates began to increase and as a consequence countries started to pay attention on how to allocate the profits across entities. Starting from this point, during the time there was outlined the “transfer pricing” concept. In fact, the notion of transfer pricing involves the prices charged between affiliated entities (e.g. entities belonging to the same group of companies) for the sale/ acquisition of goods or for the provision of services. In the literature, Satapathy (2001) defined the transfer prices as being the prices charged between the affiliates or divisions of the same group, as well as prices charged by the affiliates to the parent entity or vice versa for the transfer of services or goods.

Peralta et al. (2006) considered that taking into account that multinationals own entities in different countries of the world, these can take advantages from the differences among tax rates manipulating in this respect the transfer prices. Rollinson (2001) noted that as a consequence of an increasing in the intra-group transactions` volume governments started to be aware that the transfer pricing can affect the value of the revenue collected by them. In this context, and considering that “the role of taxes in formation of the budget revenues is undeniable” (Dobrota, 2016), Raimondos-Møller and Scharf (2002) pointed out that in order to combat the practice of multinationals regarding the transfer pricing manipulation with the aim of moving profits from a low-tax jurisdiction into a high one, governments started to develop and implement transfer pricing regulations. The scope of these regulations is to assess the fairness of the transfer prices, having as base the “arm`s length principle”. According to this principle, the price charged between affiliated entities should be the same with the price charged between independent parties performing similar transactions, in comparables circumstances to those of the transaction performed between the affiliated entities.

Furthermore, in order to develop transfer pricing regulations at global level, in 1979 the Organization for Economic Co-operation and Development (“OECD”) published a report which envisaged the allocation of profits among affiliated entities. This original report was modified and updated during the time, the last version being published in 2017 under the name *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (“OECD Transfer Pricing Guidelines”). This report contains details and explanations regarding the following aspects involved by a transfer pricing analysis (i.e. an analysis which have as a scope the assessment of the fairness of the transfer prices used for the provision of goods or services between affiliated entities): the arm`s length principle; transfer pricing methods; comparability analysis; approaches regarding the transfer pricing disputes; transfer pricing documentation; aspects regarding the intangibles; aspects regarding the intra-group services; cost contribution agreements; transfer pricing aspects related to the business restructurings.

Regarding the transfer pricing analysis, according to Rossing et al. (2017), this process involves the following main steps:

- identification and presentation of the related-party transaction subject to the analysis;
- functional analysis (i.e. presentation of the functions carried out, risks assumed and assets used by each entity, part of the transaction under analysis);
- selecting of the most appropriate transfer pricing method;
- performing of the comparability study (i.e. the benchmark study).

The benchmark study is very important in the context of a transfer pricing analysis as it is influenced by all the steps involved by such an analysis – i.e. based on the presentation of the related-party transaction is performed the functional analysis which influences the decision regarding the selection of the transfer pricing method, this method influencing the way in which the benchmark study is performed. Furthermore, based on the results of the benchmark study there could be assessed if a related-party transaction complies or not with the arm`s length principle.

Given all the above, the objective of this paper is to illustrate based on a case study how should be performed a benchmark study for a related-party transaction which involves the provisions of IT services (there was chosen the IT sector as in the recent years this had a favorable evolution in terms of expansion). The aim is also to present the relevant provisions from the OECD Transfer Pricing Guidelines applicable in the case of the benchmark study presented.

Considering that the transfer pricing analysis is relatively a new concept studied within the literature, the present paper could be utile for the professionals from the accounting and taxation area in order to understand the mechanism and the process behind a benchmark study.

## 2. Research methodology

The research methodology is based on a qualitative approach, using in this respect both a practical and a theoretical perspective. In this respect, there was performed a detailed analysis of the OECD Transfer Pricing Guidelines in order to identify those provisions which are applicable for the benchmark study presented within this paper.

The case study was used as a research tool in order to illustrate how the provisions of the OECD Transfer Pricing Guidelines should be applied for the purpose of a benchmark study. It is important to mention that the case study envisage only the performance of a benchmark study in accordance with the OECD Transfer Pricing Guidelines` provisions and does not include the performance of a whole transfer pricing analysis.

Performing a benchmark study means to identify independent entities (i.e. those entities which are not in an affiliation relationship with other parties) which carry out similar transactions, in comparable circumstances to those from the related-party transaction analyzed. Furthermore, a benchmark study involves the computation of profitability indicators for the entities selected as comparables. Therefore, the necessary information needed for the purposes of a benchmark study

can be found within specialized databases. Given this, in the case study presented below there was used the online version of Orbis database.

Orbis is an international database developed by Bureau van Dijk and includes information on approx. 400 million companies across the globe. The main information provided by Orbis for the purpose of a benchmark study are the financial data and the ownership structure of the entities.

### 3. Case study – how to perform a benchmark study

IT Services RO and Production BG are two entities part of the Afla Group. The main activity of IT Services RO consists in the provision of software development services, while the main activity of Production BG is represented by the production of shoes. During 2019, in order to obtain a good management of the production process, Production BG required its affiliated entity IT Services RO to develop a dedicated software in this respect. Based on the functional analysis there was concluded that IT Services RO acts as a service provider.

For the purpose of this paper, the transfer pricing analysis is performed from the perspective of the service provider, IT Services RO. Therefore, the benchmark study is concentrated on the identification of independent entities that provide software development services, similar to those provided by IT Services RO and which have a comparable functional profile to that of IT Services RO.

The transfer pricing method selected is the transactional net margin method, applied in a similar approach with the cost plus method, while the profitability indicator used in order to apply this method is net cost plus (“NCP”), computed based on the below formula. There is assumed that during 2019 IT Services RO obtained a NCP of 30% from the provision of software development services to its affiliated entity Production BG.

$$\text{Net cost plus (NCP)} = \frac{\text{Operational result}}{\text{Operational costs}} * 100$$

Based on the benchmark study there is determined a range of values regarding the NCP obtained by independent entities comparable with IT Services RO. If the NCP obtained by IT Services RO of 30% falls within this range, then the price charged by IT Services RO to Production BG complies with the arm`s length principle.

During the last three years IT Services RO obtained a turnover between EUR 400,000 and EUR 2,000,000.

#### Search strategy applied in order to identify independent entities comparable with IT Services RO

In order to identify independent entities comparable with IT Services RO there should be applied two categories of criteria:

- criteria applied in the Orbis database;
- qualitative and quantitative criteria applied manually on the sample of entities exported from the Orbis database in order to ensure a high degree of comparability with the tested-party (i.e. IT Services RO).

Table 1 below presents in details each of the two criteria categories.

**Table 1** Search strategy

<i>Details</i>	<i>Description</i>
<b>I. Criteria applied in the Orbis database</b>	
<b>1. Status of the activity</b>	
Paragraph 3.43 of the OECD Transfer Pricing Guidelines mentions that when performing a comparability analysis	For the purposes of the benchmark study there should be selected entities that are not in a special situation

<i>Details</i>	<i>Description</i>
there should be eliminated entities which are in a special situation (e.g. inactive entities, bankruptcy entities). This is due to the fact that these entities could distort the results of the analysis.	(i.e. only the active entities).
<b>2. Geographical criterion</b>	
Regarding this criterion, the OECD Transfer Pricing Guidelines do not include provisions for a hierarchy (for e.g. first should be performed a search on the local market and only in case of comparables lack on this market to expand the search on other markets such as EU).  However, many countries have implemented in the local law such a hierarchy for the geographical criterion.	Considering that IT Services RO is a Romanian entity which provides services on the Romanian market, the search was conducted selecting as geographical criterion the Romanian market.  If there is not obtained a sufficient number of comparables (according with the Romanian practice this involves a number of 5 entities), then the search could be expanded on the EU market.
<b>3. Activity code</b>	
When applying the transactional net margin method, the OECD Transfer Pricing Guidelines recommend to search for independent entities which have a functional profile similar to that of the tested-party and which performs activities similar to those of this entity.  In order to identify these entities there is applied a criterion related to the activity code classification. In this respect there is used the NACE Rev.2 convention.	For the purposes of the benchmark study there were selected entities which have the same NACE Rev. code as IT Services RO: <i>6201 “Computer programming activities”.</i>
<b>4. Independence</b>	
Paragraph 3.43 of the OECD Transfer Pricing Guidelines provides that a comparable transaction should be performed between independent parties. Given this, there should be applied a criterion in order to ensure the independence of the entities selected from the Orbis database (i.e. in order to ensure that these entities are not involved in related-party transactions).  The OECD Transfer Pricing Guidelines do not contain provisions regarding the ownership percentage based on which two entities are considered related-parties. However, in the practice of many countries there is used an ownership percentage of 25%.	In order to ensure the independence of the entities selected for the benchmark study there were applied the following criteria in the Orbis database: <ul style="list-style-type: none"> <li>• there were selected the independence indicators “A-“, “A”, “A+” which take into consideration the ownership percentage of 25%;</li> <li>• there were rejected entities with shareholders which owns directly or indirectly 25% or more than 25% of the shares;</li> <li>• there were rejected entities which owns 25% or more in its subsidiaries;</li> <li>• there were included only entities with unconsolidated financial indicators (“U1” classification from the Orbis database).</li> </ul>
<b>5. Period of comparison</b>	
Paragraph 3.76 of the OECD Transfer Pricing Guidelines, recommends that in the context of a comparability analysis to examine data from the year under analysis, but also data from previous years.  In practice, there is usually used a period of three years.	Therefore, the NCP obtained in 2019 by IT Services RO from the provision of software development services to its affiliated entity Production BG was compared with the range of values regarding the average NCP obtained by comparable independent entities during 2017-2019.
<b>II. Quantitative criteria</b>	
<b>1. Financial data available</b>	
This filter was applied in order to ensure the necessary financial data needed for the computation of the average NCP recorded by the independent comparables.	There were eliminated those entities for which the financial data is not available for all the three years considered in order to compute the average NCP (i.e. 2017, 2018 and 2019).
<b>2. Value of the turnover</b>	
Paragraph 3.43 of the OECD Transfer Pricing Guidelines recommends the application of quantitative criteria related to the value of sales.	Considering that during 2017 – 2019 IT Services RO obtained a turnover between EUR 400,000 and EUR 2,000,000 there were eliminated from the sample those entities which recorded an average turnover lower than EUR 400,000 or higher than EUR 2,000,000.

<i>Details</i>	<i>Description</i>
<b>III. Qualitative criteria</b>	
<b>1. Availability of websites</b>	
In this search step there is accessed the website of each entity remained in the sample until this stage. Based on the information from the website are analyzed the activities performed by the entities, but also other relevant information.	Based on this criterion, all companies from the sample should have a website which provides the needed information for the purposes of the benchmark study. Therefore, there should be eliminated those companies which do not have a website or which have the website under construction.
<b>2. Independence</b>	
This filter was applied in order to eliminate those companies which are part of a group.	Based on the information published on its websites, there was rejected entities belonging to a group of companies.
<b>3. Comparability between functional profile and activities</b>	
Based on the information published on its website, for each entity remained in the sample until this filter are analyzed the activities performed and all the information available in order to ensure the comparability with the tested-party (i.e. IT Services RO) from the perspective of both the functional profile and the services provided.	There should be eliminated from the sample those companies which perform services different to those provided by IT Services RO and which have a different functional profile.

Source: own processing

In figure 1 below is presented the print screen from the Orbis database, illustrating the first category of criteria applied.

**Figure 1.** Print Screen from Orbis database

Search step	Result for:	Step
1. Status: Active	270,267,979	
2. World region/Country/Region in country: Romania	3,420,310	
3. NACE Rev. 2 (Primary codes only): 6201 - Computer programming activities	1,421,755	
4. BvD Independence indicator: A+, A, A-	5,607,456	
5. Shareholders with subsidiaries by profile: owned between 25% and 100%	7,636,952	
6. Subsidiaries with shareholders by profile: owning between 25% and 100%	72,426,595	
7. Consolidation code: U1 (unconsolidated accounts with no consolidated companion)	40,223,944	
<b>Total:</b>	<b>38</b>	

Source: <https://orbis.bvdinfo.com>

The second category of criteria (quantitative and qualitative criteria) was applied manually in the Microsoft Excel application. Table 2 below presents a summary regarding the number of entities rejected after the application of each criterion, including the final number of comparables considered for the purpose of the benchmark study.

**Table 2** Summary of the criteria applied within the benchmark study

Criteria applied	No. of checked companies	No. of companies eliminated
Initial sample (obtained based on the criteria from the Orbis database)	38	n/a
<b>Quantitative criteria</b>		
Financial data available	22	16
Value of the turnover	10	6
<b>Qualitative criteria</b>		
Availability of websites	0	6
Independence	0	6
Comparability between functional profile and activities	1	5
<b>No. of accepted companies</b>		<b>5</b>

Source: own processing

As could be observed from the above table, after the application of all criteria there was obtained a final sample of 5 independent comparable entities.

#### *Computation of the comparability range and conclusions of the benchmark study*

For each of the 5 companies there was computed the average NCP considering in this respect the period 2017- 2019. Further on, based on the values of the average NCP computed for each entity there was determined the comparability range using in this respect the “quartile” function available in the Microsoft Excel application. Table 3 below presents the comparability range obtained.

**Table 3** Comparability range

Range	Average NCP 2017-2019
Minimum	22.85%
Quartile 1	27.74%
Median	32.13%
Quartile 3	73.65%
Maximum	151.74%

Source: own processing

The OECD Transfer Pricing Guidelines recommend to eliminate the minimum and the maximum values from the comparability range. Therefore, in the end, the final comparability range is situated between 27.74% and 73.65%, having a median value of 32.13%.

Given all the above, the 30 % NCP obtained by IT Services RO from the provision of software development services to its affiliated entity Production BG is situated within the comparability range (i.e. between 27.74% and 73.65%). Therefore, there could be concluded that the price paid by Production BG to IT Services RO complies with the arm`s length principle.

### 3. Conclusions

As a final remark it is important to note that transfer prices are not an exact science and therefore the criteria applied for the purposes of the benchmark study presented within the above case study should not be considered as fixed criteria to be followed in any benchmark study. More exactly, the benchmark study presented within this paper should not be understood as a universal recipe, but rather as an example based on which the readers could familiarize with the mechanism involved by a benchmark study. When performing a benchmark study there should be considered the functional analysis and particularities and terms of the analyzed transaction and based on these to determine the search strategy.

Moreover, each criterion from the search strategy should be chosen based on the applicable transfer pricing legislative framework and based on the particularities of the analyzed transaction. Even if many countries follow the provisions of the OECD Transfer Pricing Guidelines, there could be implemented at national level certain legislative regulations which provide for specific criteria related to the benchmark study. Given this, if for example the parent entity of a multinational group performs the same transaction with more affiliated entities and prepare a benchmark study for this type of transaction, this not means that the respective benchmark study could be used also by the affiliated entities for the purpose of a transfer pricing analysis. Each affiliated entity should ensure the compliance of the benchmark study with the specific local regulations applicable in this respect.

On the other hand, during a tax audit the tax authorities may not agree with the search strategy applied by a taxpayer in order to perform a benchmark study and select the independent comparable entities. In this context, as outlined above, it is important that the taxpayer should be able to sustain each criteria and step applied based on legislative provisions correlated with the particularities and the functional profile involved by the analyzed transaction.

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