ICMAI
The Institute of
Cost Accountants of India
(Statutory Body under an Act of Parliament)
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PRACTICAL GUIDE ON

Price Determination Methods under Indian Transfer Pricing Regulations

THE INSTITUTE OF
COST ACCOUNTANTS OF INDIA

Headquarters:
CMA Bhawan, 3, Institutional Area, Lodhi Road, New Delhi - 110003

Kolkata Office:
CMA Bhawan, 12, Sudder Street, Kolkata - 700016

Direct Tax

Behind Every Successful Business Decision, there is always a CMA

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असतोमा सद्गमय तमसोमा ज्योतिर् गमय मृत्योर्मामृतं गमय ॐ शान्ति शान्ति शान्तिः	From ignorance, lead me to truth From darkness, lead me to light From death, lead me to immortality Peace, Peace, Peace

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Genesis of Transfer Pricing Regulations

Globalization refers to the increasing inter-connectedness and inter-dependence of economies, businesses, and markets across the world. It has led to the free flow of goods, services, capital, technology, and labor across borders.

As companies expanded their footprints beyond domestic boundaries, they began to set up their Special Purpose Vehicles (SPV) in form of subsidiaries, joint ventures, branches, and service centers in different countries, giving rise to complex, multi-country operations. This expansion has drastically transformed how businesses operate, from sourcing raw materials in one country to manufacturing in another, and marketing and servicing customers across multiple regions. As a result, a multinational enterprise (MNE) operates in an integrated manner, with its different entities focusing on specific functions like manufacturing, distribution, customer service, and R&D, often in different parts of the world.

In this globalized business environment, **related party transactions (RPTs)** have become preferable and essential. These transactions occur between entities that are part of the same multinational group — often referred to as **associated enterprises (AEs)**. RPTs include the sale or purchase of goods, services, licensing of intellectual property, financial transactions like loans, providing of corporate guarantees, or the sharing of administrative services, employees, and infrastructure between group companies.

The need for these transactions arises from the way multinational businesses are structured. For instance, a company may manufacture goods in a low-cost country, handle R&D in another, and market its products in various regions. In this structure, the different entities must engage in internal transactions to facilitate the movement of goods, services, and capital across the organization.

Another significant reason for RPTs in a globalized world is the centralization of business functions for greater efficiency. Shared Service Centers (SSCs), which provide services such as HR, finance, IT, and legal support, are common in multinational corporations. These centers are often located in countries with lower operating costs, and they charge the parent company or other subsidiaries for their services. This structure helps streamline operations across the organization while keeping costs low.

Moreover, MNEs enter into RPTs for legal and accounting compliance reasons. For example, when one subsidiary provides a guarantee to another or makes intercompany loans, these transactions need to be properly recorded and reported for tax and accounting purposes, often triggering related party pricing.

However, because these transactions occur between related entities, there is a risk that MNEs might **manipulate prices to shift profits to low-tax jurisdictions**, reducing their overall tax

liabilities. To counter this, countries have established **Transfer Pricing (TP)** laws, which ensure that these transactions are conducted at **"arm's length"** — that is, under the same terms and conditions that would apply if the transactions were made between unrelated parties.

Transfer pricing regulations are crucial in maintaining fairness and transparency, preventing tax avoidance, and ensuring that profits are appropriately allocated to countries where economic activity actually takes place.

Therefore, globalization has necessitated the rise of related party transactions as MNEs expand their operations globally and integrate various business functions across borders. These transactions are essential for managing global supply chains, intellectual property, and centralized services, but they also create **significant tax and regulatory challenges**.

As such, countries, including India, have put in place strict transfer pricing laws to ensure that these internal transactions are priced fairly and that multinational corporations contribute a **fair share of taxes** in the jurisdictions where they operate.

To sum up, if international transactions are between independent or unrelated entities, it is presumed that transactions have no influence of relationship and respective entities will pay the due taxes in their own countries. Thus, no need of making any such regulation on price determination. **Therefore, genesis of effecting transfer pricing regulation is mainly because of related party transactions**, where it is presumed that their relationship may have influence on transaction pricing.

Global evolution of Transfer Pricing Laws

Over the past century, global transfer pricing regulations have transformed from fundamental legal provisions to refined frameworks aligned with international cooperation and transparency.

Early Legislative Foundations -

The concept of transfer pricing regulation first took shape during World War I. The United Kingdom introduced anti-avoidance rules in 1915, followed by the United States in 1917, to prevent artificial shifting of profits through intra-group pricing manipulation. However, these early rules had limited reach and clarity.

Growth in Regulatory Complexity

As cross-border trade and the presence of multinational groups grew post-1960, countries began strengthening their domestic transfer pricing rules. The 1970s and 1980s saw the rise of complex tax planning structures, prompting countries to develop technical expertise to tackle profit shifting to tax havens. The UK introduced Controlled Foreign Corporation (CFC) rules in 1984 to combat offshore accumulation of profits.

Organization for Economic Co-operation and Development (OECD)

The **Organization for Economic Co-operation and Development (OECD)** is an international organization founded in **1961** to promote policies that improve global economic and social well-being. Headquartered in **Paris.**

The OECD serves as a platform where governments work together to address common challenges, share best practices, and coordinate policy responses in areas such as **taxation, trade, education, innovation, environment**, and **economic development**.

It is especially known for setting global standards, such as the **OECD Transfer Pricing Guidelines** and the **Base Erosion and Profit Shifting (BEPS) framework**, aimed at ensuring fair and transparent tax practices worldwide. More information and importance of OECD is discussed in later part of booklet.

Evolution of transfer pricing (TP) laws in India

The **evolution of transfer pricing (TP) laws in India** has been closely tied to the growth of globalization and the increasing presence of multinational enterprises (MNEs) operating in and out of the country.

Before 2001, India lacked a specific framework to regulate cross-border transactions between related parties, which left room for profit shifting and base erosion.

However, with liberalization and the influx of foreign investment in the 1990s, it became necessary to align India's tax regime with global standards to ensure fair taxation and prevent manipulation in intercompany transactions.

India formally introduced transfer pricing regulations through the **Finance Act, 2001.**

These provisions were aligned broadly with **OECD Guidelines** and were aimed at curbing tax avoidance by **Multinational Enterprises (MNEs)** through related-party transactions.

As the global tax landscape evolved, India made further refinements to its TP laws. The Finance Act, 2012 introduced **domestic transfer pricing** provisions for certain specified domestic transactions, mainly to prevent abuse of tax exemptions and deductions. However, these provisions were later rolled back from FY 2016-17 onward for most transactions, as they were found to cause excessive litigation.

India's transfer pricing regime today is broadly in line with **international norms**, particularly the OECD guidelines. While significant progress has been made in improving transparency and compliance, challenges remain in areas such as dispute resolution, access to reliable comparable, and valuation of intangibles. Nevertheless, India continues to refine its approach through policy updates, administrative guidance, and global cooperation.

Legal Framework of Transfer Pricing in India

The **Income-tax Act, 1961** incorporates **transfer pricing regulations** to ensure that transactions between **related parties (associated enterprises)** are conducted at **arm's length**, preventing manipulation of profits and safeguarding India's tax base. These provisions apply to both **international transactions** and certain **domestic transactions** where tax advantages could be misused.

Key Sections of the Act

1. **Section 92 – Computation of Income from Related Party Transactions**

   Mandates that income from **international or specified domestic transactions** between associated enterprises must be computed using the **Arm's Length Price (ALP)**.

2. **Section 92A – Definition of Associated Enterprises (AEs)**

   Defines AEs based on parameters such as ownership, management, control, or participation in financial or business decisions.

3. **Section 92B – Definition of International Transactions**

   Covers transactions involving transfer of tangible goods, services, intangibles, capital financing, cost-sharing arrangements, or business restructuring.

4. **Section 92BA – Specified Domestic Transactions (SDTs)**

   Introduced via the Finance Act, 2012 to cover high-value domestic transactions, especially where one party benefits from tax incentives.

5. **Section 92C – Methods for Determining Arm's Length Price**

   Specifies the use of prescribed methods (e.g., CUP, TNMM, Cost Plus) to determine whether the transaction price aligns with the arm's length standard.

6. **Section 92CA – Role of Transfer Pricing Officer (TPO)**

   Authorizes the **TPO** to scrutinize and determine ALP during tax assessments.

7. **Section 92D – Documentation Requirements**

   Requires taxpayers to maintain documentation justifying the ALP and functional analysis of related-party transactions.

8. **Section 92E – Mandatory Reporting via Form 3CEB**

   Taxpayers must submit this form, certified by a Chartered Accountant, along with their tax return if they have undertaken such transactions.

9. **Sections 92CB & 92CC – Safe Harbour Rules and Advance Pricing Agreements (APA)**

   Provide tools for reducing litigation and bringing certainty by pre-agreeing pricing methods or using simplified benchmarks.

10. **Section 286 – Country-by-Country Reporting (CbCR)**

    Enacted as part of India's implementation of **OECD's BEPS Action 13**, requiring large MNEs to report jurisdiction-wise financial and tax data.

Supporting Rules under the Income-tax Rules, 1962

The transfer pricing framework under the Indian Income-tax Rules is detailed through a comprehensive set of rules, primarily **Rules 10A to 10T**, which supplement the provisions of Sections 92 to 92F of the Income-tax Act, 1961.

Rules 10A to 10T: Core Transfer Pricing Provisions

These rules govern the operational aspects of determining the arm's length price (ALP), documentation standards, and procedural matters.

Key areas covered include:

- **Rule 10A**: Definitions of terms used in ALP computation.
- **Rules 10B & 10C**: Application and selection of the **Most Appropriate Method** (MAM).
- **Rules 10D to 10G**: **Documentation requirements** (Local File) and procedures during assessment and audit.
- **Rules 10H to 10T**: Cover procedures for **Advance Pricing Agreements (APAs)**, including eligibility, filing, negotiation, and compliance.

Rules 10DA and 10DB: Three-Tiered Documentation for MNEs

These rules implement India's compliance with OECD's BEPS Action Plan 13 through a three-tier documentation structure:

- **Rule 10DA**: Pertains to the **Master File** and **Local File** requirements for Indian entities that are part of a multinational enterprise (MNE) group. It prescribes thresholds and filing procedures (Form 3CEAA and Form 3CEAB).

- **Rule 10DB**: Deals with **Country-by-Country Reporting (CbCR)** for international groups with consolidated revenue exceeding prescribed thresholds. It covers obligations for filing **Form 3CEAD** and **Form 3CEAE**, along with timelines and conditions for constituent entities.

Further, these provisions continue to evolve, responding to global tax developments and domestic policy needs.

Understanding Practical aspects of Transfer Pricing and its applicability

Fundamentally, transfer pricing refers to the pricing of goods, services, or intangible assets in transactions between **associated enterprises** — that is, enterprises under common ownership or control. When such related parties engage in cross-border or specified domestic transactions, there is a potential risk that profits may be shifted from one jurisdiction to another by manipulating prices.

To address this, Indian tax law requires that these transactions be conducted at an **arm's length price (ALP)**. The ALP is the price that would be charged between unrelated parties in comparable circumstances.

The objective of transfer pricing regulation is to ensure that India receives its fair share of tax from economic activities carried out within its borders and to prevent erosion of the tax base through artificial pricing arrangements.

These rules apply to both **international transactions** involving one or more non-resident associated enterprises and to certain **specified domestic transactions** exceeding prescribed thresholds.

In summary, transfer pricing in the Indian context is a legal and fiscal framework designed to ensure that inter-company transactions reflect market-based outcomes and do not distort the tax liabilities of multinational or group entities.

Let's understand, when Transfer Pricing principles apply.

Imagine you're running a business with branches or associates around the world—or even just across states in India. You buy, sell, lend, borrow, and share services or technology within your own group.

Now the big question is: **Are you charging fair prices, just like you would deal with outsiders?**

That's where **transfer pricing rules** come in. They kick in when transactions between **related parties** need to be **monitored and priced fairly**, so no one shifts profits to another tax jurisdiction, just to dodge taxes.

Although, transfer pricing is also applicable in case of some domestic transactions. They are called **Specified Domestic Transaction (SDT)**, details on SDT has been provided in later part.

International transfer pricing laws first apply when you deal across borders. Here's what qualifies:

- ✓ There should be a **transaction**—like buying or selling goods, services, intellectual property, lending money, or sharing costs
- ✓ It happens between **Associated Enterprises (AEs)**—think parent companies, subsidiaries, or sister concerns
- ✓ And—at least one of them is a **non-resident**
- ✓ If that transaction affects your income, profit, loss, or assets in India—it must follow **Arm's Length Pricing** (ALP). That means the price should be the same as if you were dealing with a totally unrelated parties.

Let's understand each of the important highlighted terms in detail including some deeming fictions:

1. International Transaction

What is a "Transaction"?

In the world of transfer pricing, a **"transaction"** isn't just a simple sale or purchase. It's a **broad term** that captures **any exchange of value** between two related parties—whether across borders or within the country—that could **influence taxable income**. And yes, even a handshake deal or an internal memo can count!

Legal Definition:

Under **Section 92F(v)** of the **Income-tax Act, 1961**, a transaction includes any **arrangement, understanding, or action in concert**—whether formal or informal, written or oral, and whether or not legally enforceable.

So, if you're part of a **multinational group** or even a **domestic group of companies**, and you're doing business with your own affiliates, group companies, or sister concerns, you need to check: **Is there value being exchanged?** If yes, then you've got a transfer pricing transaction.

The key categories of **international transactions** (with applicable sections and examples) include:

I. **Tangible Property Transactions (Physical Goods/Assets)** – Deals involving **tangible property** between AEs. This covers the purchase, sale, transfer, lease or use of physical assets such as **equipment, machinery, vehicles, buildings, commodities, or any other articles/products**.

II. **Intangible Property Transactions (Intellectual Property Rights)** – Transactions involving **intangible assets or intellectual property** between AEs. This includes the purchase, sale, transfer, lease or use of intangibles such as **patents, copyrights, trademarks, licenses, franchises, customer lists, marketing channels, brands, technical know-how or any other commercial rights of similar nature.**

Example: An Indian company licenses a patent or trademark from its foreign affiliate and pays a royalty; this transfer of IP rights is an international transaction subject to transfer pricing.

Important Note

- The CBDT (Finance Act 2012) explicitly clarified that a wide range of intangibles are included in "international transactions."
- OECD guidelines similarly emphasize that inter-company transfers of valuable intangibles must be at arm's length.
- Indian case law has scrutinized so-called **marketing intangibles** (e.g. an Indian subsidiary's advertising expenditure that builds the foreign parent's brand); such arrangements may be considered international transactions if an AE benefits, requiring arm's length compensation.

III. **Provision of Services** – Intra-group **services** provided between AEs. Any "provision of services" between related parties and the explanation expands this to include **market research, market development, marketing management, administration, technical services, repairs, design, consulting, agency services, R&D (scientific research), legal, accounting, or similar services.**

Example: A parent company provides management consulting and IT support to its Indian subsidiary for a fee, or an Indian entity provides back-office support services to an overseas affiliate.

Important Note

- Even if certain support services are provided without charge, tax authorities may determine an arm's length fee. OECD guidance uses the "**benefit test**" – i.e. whether an independent enterprise would be willing to pay for the service – to evaluate intragroup services. Indian tribunals have held that the necessity or benefit of a service to the recipient should not be second-guessed if the service was actually rendered; instead, the focus is on whether the charge is at arm's length.

IV. **Capital Financing Transactions** – Financial arrangements and funding transactions between AEs. This category explicitly includes inter-company **loans and borrowings**, **inter-corporate deposits**, **credit guarantees**, the **purchase or sale of marketable securities** (e.g. related-party shares or bonds), **advances** or deferred payment arrangements, and any other **debt** arising during the course of business. In essence, all forms of **capital financing or credit support** between AEs are covered.

Example: An Indian company provides an interest-free loan to its foreign subsidiary, or a parent company offers a corporate guarantee for its Indian affiliate's bank loan – such transactions must be assessed as if made at arm's length (implying an interest rate or guarantee fee that unrelated parties would agree to).

Important Note

- **Clarification:** The 2012 amendment to the law clarified that even indirect financial benefits (like extended credit periods on sales or outstanding receivables beyond normal terms) are considered international transactions if they affect an AE's profits.
- Courts have also affirmed that corporate guarantees given for an AE's debt are within the ambit of transfer
- **Note:Equity capital transactions** (e.g. issue of shares by an Indian company to its foreign parent) are generally **not** covered as international transactions since they do not inherently give rise to income.

V. **Cost Allocation or Cost Contribution Arrangements** – Agreements where two or more AEs **share or apportion costs** in connection with a common benefit, facility or service. Any mutual agreement for the allocation or contribution to a cost or expense between AEs is deemed an international transaction.

Example: An Indian subsidiary and its foreign parent enter into a cost-sharing agreement for R&D or global marketing: each company pays a portion of the total expense. Such cost contributions must be consistent with the arm's length principle (each entity should bear costs in proportion to the benefit it expects).

Applicable Section: Section 92B(1) explicitly includes **cost allocation arrangements** between AEs ("any mutual agreement… for the allocation or apportionment of, or contribution to, any cost or expense").

Important Note -

Clarification: This aligns with OECD guidance on Cost Contribution Arrangements (CCAs), which requires that participants in a cost-sharing deal share costs **proportionate to their shares of anticipated benefits**. Indian tax authorities scrutinize such arrangements to ensure no AE is subsidizing another's expenses; only the allocable share of costs borne on behalf of an AE should be charged to that AE (and no more).

VI. **Business Restructuring or Reorganization** – Cross-border business reorganizations involving AEs that affect the allocation of functions, assets, or risks within the group. The law explicitly brings within TP scope **"any transaction of business restructuring or reorganization, entered into by an enterprise with an associated enterprise"**,

irrespective of whether it has an immediate bearing on profit, income, losses, or assets at that time or only at a future date.

Example: A multinational group restructures its operations – for instance, an Indian company transfers valuable intangible assets or customer contracts to a foreign group entity, or an independent distributor in India is restructured into a "**limited-risk distributor**" for the group (with major strategic functions shifted to an overseas AE).

Such reorganizations between AEs are treated as international transactions, ensuring that any transfer of profitable assets or rights is compensated at arm's length (e.g. an exit payment to the entity surrendering profit potential).

Applicable Section: Covered under **Section 92B's Explanation (i)(e)** (which was inserted in 2012 to cover business restructurings between AEs).

Important Note-

Clarification: This provision reflects OECD Transfer Pricing Guidelines (Chapter IX) which stress that when group businesses are restructured (for example, a profitable operation is converted to a cost-center or assets are relocated), one must examine whether an independent party would require compensation. Indian authorities similarly evaluate if the entity losing functions or assets in a group reorganization received an arm's length consideration for the change in its economic position.

VII. **Other Transactions** – A broad **residuary category** for any **other inter-company transaction** irrespective of the fact that can impact the profits, incomes, losses, or assets of the enterprises or not.

Even if a dealing doesn't fall neatly into the above categories, it may be an international transaction.

Applicable Section: The **main definition in Section 92B(1)**.

Important Note-

Clarification: The Finance Act 2025 has amended the definition of transaction to remove the condition relating to the impact on the profits, income, losses or assets. Meaning thereby, irrespective of whether or not the transaction has bearing on the profits, income, losses or assets, it can still qualify as an international transaction.

The amendment shall have an impact in relation to transactions such as corporate guarantee, issue of share capital and other capital financing transactions. In the existing law, one could have argued that said transactions do not qualify as international transaction as they do not have impact on profits, income, losses or assets. Post

enactment of the IT Bill, such argument may not be available in the light of the widened scope of definition of 'international transaction'.

VIII. **Deemed International Transactions** – A special look-through provision to catch transactions that are **structured via third parties**. Under Section 92B(2), if an enterprise in India enters into a transaction with an unrelated party, but **there exists a prior agreement in relation to that transaction between the unrelated party and the AE**, or **the terms of the transaction are determined in substance by the AE**, then the transaction is **deemed** to be an international transaction between the AEs.

In other words, inserting an independent third-party will not avoid TP if the deal was effectively controlled by related parties.

Example: An Indian company purchases raw materials from an unrelated local supplier, but the pricing and other key terms were pre-fixed under a contract between that supplier and the Indian company's foreign parent. Although the immediate contract is with an independent party, Section 92B(2) will deem it an AE transaction between the Indian company and its foreign parent, since the parent orchestrated the terms.

Applicable Section:Section 92B(2) (as amended by Finance Act 2014) covers such **tripartite arrangements**, and it explicitly applies **regardless of whether the intermediary third party is a resident or non-resident**.

Important Note-

Clarification: This anti-avoidance rule was introduced to prevent AEs from bypassing transfer pricing by routing transactions through third parties. CBDT in 2014 clarified the scope to include cases where the third party is an Indian entity as wellmasllp.com. OECD guidance likewise endorses looking at the **substance over form** – tax authorities may disregard the interposed entity and evaluate the controlled transaction between AEs. Indian case law has applied this provision in situations where global agreements or supply chain arrangements effectively dictated the terms of an Indian entity's transaction with an independent party, thereby bringing it under transfer pricing scrutiny as a deemed international transaction.

2. Specified Domestic Transactions (SDTs)

A Practical Overview

The concept of **Specified Domestic Transactions (SDTs)** was introduced by the **Finance Act, 2012**, by inserting an expanded definition under **Section 92BA** of the Income-tax Act, 1961. Prior to that, transfer pricing provisions applied only to **international transactions** between associated enterprises.

Objective is to prevent profit shifting between related domestic entities where at least one of them enjoys tax benefits like deductions or exemptions, thereby causing revenue leakage for the exchequer.

SDT provisions apply **only if the aggregate value of such transactions exceeds ₹ 20 crore** in a financial year. Once the threshold is crossed, all relevant transactions must be benchmarked using one of the prescribed TP methods. The assessee must maintain proper documentation as per rule and ensure necessary compliance.

Common examples of SDTs include a tax holiday unit transferring goods to a regular business division, or a SEZ unit receiving services from another company within the group. In such cases, the pricing must reflect arm's length terms, and any overstatement of profits or understatement of expenses can lead to adjustments.

Taxpayers must therefore carefully assess SDT applicability, maintain contemporaneous documentation, and benchmark all relevant domestic related-party transactions.

Despite being narrower in scope than international transfer pricing, SDTs carry serious compliance requirements. Proper planning, internal controls, and coordination between tax and finance teams are essential to ensure full adherence to the law. Specified Domestic Transactions are subject to the same rigor of arm's length pricing as international transactions when the prescribed monetary threshold is met. These provisions are aimed at curbing tax arbitrage in domestic group structures, particularly where profit-linked deductions or related party arrangements exist. A proactive and well-documented TP policy is essential for ensuring compliance and avoiding litigation.

Here are few examples to understand the need of transfer pricing in specified domestic transaction:-

Example 1: **Internal Sale of Electricity**

A manufacturing company has a power-generating unit, which is eligible to claim deduction under Section 80-IA and its 100% profit is exempt from tax. If this exempt unit sells electricity to its own plant and decides price at its own, then there are chances of manipulating price and set higher price. Therefore,the transfer price of electricity must be benchmarked (e.g., using State Electricity Board tariff) to ensure no excessive profits are booked in the eligible unit.

Example 2**: Excessive Profits in a SEZ Unit**

SEZ units are entitled to enjoy tax holiday for certain period. A SEZ unit showing unusual high profits as compared to industry norms due to pricing advantages from related-party sales. Provisions of specified domestic transaction should apply to ensure charging of fair price between related parties.

3. Associated Enterprises

Associated Enterprises (AEs) are two business entities that are closely related through ownership or control. Under Indian transfer pricing regulations, Section 92A of the Income-tax Act, 1961 defines when two enterprises are considered "associated."

In simple terms, two companies become AEs if one participates (directly or indirectly) in the **management, control, or capital** of the other, or if the same persons participate in the management, control, or capital of both companies.

To remove any ambiguity, the law provides specific conditions that establish such an association. Below is a simplified explanation of these key criteria, along with practical examples for each condition:

Key Criteria for Associated Enterprises

I. **Significant Shareholding (≥ 26% Ownership):**

If one enterprise holds, directly or indirectly, at least **26% of the voting power** in another enterprise, they are deemed associated.

Example: Company **A** owns 30% of the equity shares (voting power) in Company **B**. Since A's shareholding in B is above 26%, A and B are **Associated Enterprises**.

II. **Common Shareholder (≥ 26% in Each):**

If the **same person or entity** holds at least 26% of the voting power in **both** enterprises, the two enterprises are AEs.

Example: Investor **X** owns 40% of Company **M** and 40% of Company **N**. Here, X's common ownership (≥26%) makes **M and N associated enterprises** (even though M and N are distinct companies).

III. **Large Loan Dependency (≥ 51% Assets):**

If one enterprise has extended a **substantial loan** to another such that the loan constitutes **51% or more of the total assets** of the borrower, the two are AEs.

Example: Company **C** lends a large sum to Company **D** which equals 60% of D's total asset value. This heavy financial dependence (loan ≥51% of assets) means **C and D are associated enterprises**.

IV. **Significant Guarantee (≥ 10% Borrowings):**

If one enterprise **guarantees 10% or more** of the total borrowings (debt) of another, they are treated as AEs.

Example: Company **P** has a bank loan, and Company **Q** guarantees 15% of P's outstanding debt. Because Q's guarantee covers a significant portion of P's borrowings (≥10%), **P and Q are associated enterprises**.

V. **Control of Board/Management (Majority Appointments):**

If one enterprise can **appoint more than half of the board of directors** (or equivalent governing members) of the other enterprise, then they are AEs. In other words, one company effectively controls the management of the other.

Example:**Holding Co.** has the right to appoint 4 out of 6 directors on the board of **Subsidiary Co.** By controlling the majority of Subsidiary Co.'s board, Holding Co. ensures **both companies are associated enterprises**.

VI. **Common Board Control (Same Person Appointing Directors):**

If **the same person or persons** appoint more than half of the board of directors (or one or more key executive directors) in **each** of the two companies, those companies become AEs.

Example: Suppose **Mr. Y** is a major investor who has the right to appoint a majority of directors in **Company E**and in **Company F**. Because Mr. Y controls the boards of both E and F, **E and F are associated enterprises** (even if E and F don't directly own shares in each other).

VII. **Dependence on Intangibles (Know-how/IP):**

If one enterprise's business is **wholly dependent on intangible assets** (know-how, patents, trademarks, franchises, licenses, etc.) **owned by the other enterprise**, they are AEs. In practice, this means one company cannot carry on its core operations without rights or technology obtained from the other.

Example:**SubCo** licenses a proprietary software and patent exclusively from **HoldCo** to run its business. **SubCo**'s entire operation relies on **HoldCo**'s intellectual property, so **SubCo and HoldCo are associated enterprises**.

VIII. **Raw Material Supply Dependency (≥ 90% Supply):**

If **90% or more** of one company's raw materials and consumables are supplied by the other company (or by persons specified by the other) and **the supplier influences the price or terms** of supply, the two are AEs.

Example:**Manufacturer A** sources 95% of its raw materials from **Supplier B**, and B has the power to set or influence the pricing and terms of these supplies. This extreme dependency (≥90% supply from B) makes **Aand B associated enterprises**.

IX. **Sales Dependency (Exclusive Purchaser):**

If one enterprise **sells its goods or products mostly to the other enterprise (or to persons the other enterprise designates)**, and the other enterprise can **influence the price or conditions of these sales**, they are AEs.

Example:**X** produces goods but sells almost all of its output to **Distributor Y** (or to customers whom Y specifies), and Y dictates the pricing/terms for these sales. Since X is highly dependent on Y for its sales (with Y influencing terms), **X and Y are associated enterprises**.

X. **Common Individual Control:**

If both enterprises are **controlled by the same individual** (or that individual's relatives), they are deemed associated. Control here can refer to ownership or the power to make financial and policy decisions.

Example:**Mr. Gupta** owns a controlling stake in **Company G**, and **Mrs. Gupta** (his wife) controls **Company H**. Since the two companies are under the control of the same family (Mr. Sharma and his relative), **G and H are associated enterprises**. Similarly, if one individual directly controls two companies, those companies are AEs by virtue of common control.

XI. **Participation in Profit (Partnership/AOP interest):**

If one enterprise is a **firm, association of persons (AOP), or body of individuals (BOI)**, and the other enterprise holds **at least a 10% interest** in that firm/AOP/BOI (for example, a 10% profit share in a partnership), then they are AEs.

Example: **Company Z** has a 20% profit share in **Partnership Firm P** (i.e. Z is a partner with 20% interest in P's profits). This exceeds the 10% threshold, so **Company Z and Firm P are associated enterprises**.

XII. **Mutual Interest :**

If there exists **any other relationship of mutual interest** between the two enterprises, they can be deemed AEs. This is a broad, catch-all provision intended to cover cases of close association not covered above (to be defined by regulations).

Example: A special **joint venture agreement** between two companies creating strong interdependence could be considered a mutual interest relationship. (Note: In practice, the government would specify what qualifies as "mutual interest"; it's a placeholder for any other significant connections.)

Each of these conditions on its own is sufficient to establish an **"associated enterprise" relationship** under Indian tax law. In other words, if any one of the above criteria is met at any

time during the financial year, the enterprises are treated as associated for transfer pricing purposes.

This definition ensures that transfer pricing regulations (requiring arm's length pricing for transactions) apply only to **truly related entities**, identified through clear benchmarks like ownership stakes, control over business decisions, financial dependence, or familial ties. By understanding these key criteria, taxpayers and businesses can recognize when two entities will be considered AEs and ensure compliance with transfer pricing rules in India.

4. Arm's Length Pricing: Concept and Significance

Arm's length pricing (also known as the arm's length principle) is a foundational concept in taxation and transfer pricing that requires transactions between related parties to be priced **as if the parties were unrelated**, dealing at "arm's length."

In other words, the terms and price of a transaction between associated enterprises (such as subsidiaries of a multinational group) should mirror those that would prevail between independent entities in a **free market**. This principle is codified in many tax laws and international guidelines to ensure fairness, prevent tax avoidance, and allocate income properly among jurisdictions.

4.1. Definition under Indian Tax Law (Section 92F of IT Act, 1961)

Under **Section 92F(ii)** of the Indian Income-tax Act, 1961, "arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

In simpler terms, it is the price that **unrelated parties** would agree upon in the open market. This definition establishes the benchmark for evaluating transactions between related parties (called **associated enterprises** or AEs).

Notably, Section 92(1) of the Act mandates that any income from an international transaction with an associated enterprise **must be computed having regard to the arm's length price**, ensuring that taxable profits aren't distorted by special relationships.

4.2. Economic and Legal Rationale for the Arm's Length Principle

The arm's length principle exists to uphold the **integrity of tax systems** and the fairness of market transactions. Economically, when two independent (unrelated) parties deal with each other, each is motivated to maximize their own benefit, which drives the price toward a **market-equilibrium (fair) value**.

However, when parties are related (such as a parent company and its subsidiary), their pricing may be influenced by group interests rather than pure market forces – for instance, a company

might under price goods sold to its foreign subsidiary to shift profits to a lower-tax jurisdiction. The arm's length requirement counteracts such distortions by **simulating market conditions** even for related-party deals.

From a legal and policy standpoint, the arm's length pricing rule is crucial for **preventing tax base erosion and profit shifting**. It ensures that multinational enterprises (MNEs) pay taxes in each country commensurate with the value of economic activities performed there, rather than artificially concentrating profits in low-tax areas. As one commentary notes, the arm's length principle requires that transactions between related entities in different jurisdictions be priced as if the entities were unrelated, **ensuring fair taxation and preventing profit shifting among jurisdictions**.

In effect, each country's tax base is protected because the pricing cannot be arbitrarily set to siphon off profits. This principle thereby combats tax evasion/avoidance schemes where companies manipulate internal prices to minimize taxes. Global tax authorities view the arm's length standard as **critical for preventing profit shifting and tax evasion**, making it harder for MNEs to manipulate prices for tax advantage.

Legally, arm's length pricing is embedded in domestic laws (like India's Section 92) and is supported by tax treaty provisions. Article 9 of the OECD Model Tax Convention, for example, empowers tax authorities to adjust profits of associated enterprises if their financial relations deviate from those that would be made at arm's length. This helps avoid **double non-taxation** (untaxed income) and also mitigates double taxation when applied consistently (since if one country increases the taxable profit by enforcing arm's length pricing, the other country is generally expected to allow a corresponding adjustment).

Overall, the rationale is to treat members of a corporate group as **separate independent entities** for tax purposes rather than as one combined entity, so that each jurisdiction can tax the income that genuinely arises from activities within its borders.

4.3. Significance in International Tax

Arm's length pricing is the **cornerstone of international transfer pricing standards**. The OECD Transfer Pricing Guidelines, followed by many countries (including India), are built on the arm's length principle as the "global standard for pricing related-party cross-border transactions". This standard enjoys widespread acceptance because it aims to produce equitable results across different tax jurisdictions. By requiring related parties to price transactions as independent parties would, the principle creates a **level playing field** for businesses – multinational groups are taxed on their intercompany dealings in a manner comparable to how standalone firms would be taxed for similar external dealings.

One key goal of the arm's length framework internationally is to **eliminate double taxation** and avoid prolonged disputes between tax authorities. If every country applies the arm's length standard, the profit allocated to each jurisdiction should ideally reflect the value created there,

reducing the chances that the same income is taxed twice or, conversely, that income escapes tax altogether. The OECD explicitly notes that applying the arm's length principle helps "prevent and eliminate tax disputes" between countries' tax administrations. Most bilateral tax treaties incorporate this concept (in the Associated Enterprises article), meaning countries have agreed to adhere to arm's length pricing for cross-border related-party transactions and provide relief if an adjustment by one country would result in double tax.

The significance of arm's length pricing also appears in national regulations worldwide. For example, the United States employs a similar arm's length standard in Section 482 of the Internal Revenue Code to adjust income between related parties, and many other nations have analogous rules.

The **United Nations Practical Manual on Transfer Pricing** also endorses the arm's length principle as the primary approach for developing and developed countries alike. In sum, arm's length pricing is viewed as the fairest and most workable method to allocate income among countries in the international tax system, despite the complexities in application. (It is worth noting that alternative approaches, such as formulary apportionment, have been debated in academic circles, especially for the digital economy, but those are not yet the norm; the arm's length principle remains the predominant standard globally)

4.4. Practical Application and Examples

In practice, determining and applying an arm's length price involves **comparability analysis** and often significant documentation. Multinational companies must **justify their transfer prices** by showing that they are consistent with what independent entities under similar conditions would agree upon. This is done by finding comparable transactions or companies and adjusting for differences. The Indian regulations, for instance, require taxpayers to maintain detailed documentation and obtain an auditor's certificate to support that their international or specified domestic transactions are at arm's length.

A simple practical example can illustrate the concept: Suppose **Company A** in Country X sells goods to its subsidiary, **Company B** in Country Y. If Company A sells the same product to independent customers for ₹100 each, but sells to Company B for only ₹60, this **below-market price** could indicate a non-arm's length arrangement (perhaps intended to shift profits to Country Y).

Tax authorities in Country X would examine comparable sales and likely assert that the arm's length price for the inter-company sale should also be around ₹100. Consequently, Company A's taxable income in Country X might be increased by recalculating the revenue at ₹100 per unit (the arm's length price) instead of ₹60. Similarly, if a parent company charges its subsidiary an **excessive price** for a service or asset (above what an unrelated party would pay), the subsidiary's tax authority can reduce the deductible expense to the arm's length amount.

For instance, if a parent company loans $1 million to an overseas affiliate at 0% interest (no interest charged), an independent lender would have charged, say, 5% interest in an arm's length deal. Here, tax authorities may adjust the arrangement by imputing a 5% interest on the loan as the arm's length price of that financing, ensuring the lender pays tax on additional interest income and the borrower gets an interest deduction (if at all) only up to that arm's length rate. In all such cases, the arm's length principle serves as a **benchmark** to evaluate and adjust the financial outcomes of related-party dealings to reflect market reality.

To implement these principles, tax authorities rely on the methodsto find the appropriate price or profit margin. The choice of method depends on the nature of the transaction and available data.

For example, the Comparable Uncontrolled Price method might be used for commodity transactions where identical market prices are readily available, whereas the Transactional Net Margin Method might be applied for complex transactions by comparing profit ratios. The end goal in each case is the same: determine a price or margin that unrelated parties would have agreed to in similar circumstances, thereby establishing the arm's length outcome.

4.5. Arm's Length vs. Non-Arm's Length Arrangements

A brief comparison between arm's length and non-arm's length transactions highlights why the principle is so important:

- **Independence of Parties:** In an **arm's length transaction**, the buyer and seller act independently and have no special relationship, so neither side has undue influence over the other. Each acts in its **own self-interest**, which drives a fair bargain. In a **non-arm's length (related-party) transaction**, the parties have a **pre-existing relationship** (e.g. parent-subsidiary, common ownership, or familial ties) that can influence their behavior. The selling party might be willing to give concessions or set prices that it would not offer to an outsider because the overall benefit still accrues within the corporate family.

- **Pricing and Terms:** Arm's length dealings result in **market-based pricing**. The terms reflect what **comparable independent parties** would agree upon (no hefty discounts or inflated charges beyond market norms). By contrast, in a non-arm's length arrangement, the price or terms may deviate from market value – for example, goods sold at a discount, interest-free loans, or unusually high royalties – since the motive may be to **shift profits** or to financially support the related counterparty rather than maximize one's own profit from that single transaction.

- **Tax Implications:** Arm's length prices generally ensure each party's taxable income is proper and in line with economic reality. Non-arm's length prices, if left unadjusted, can cause **misallocation of income for tax purposes** – typically benefiting the group as a whole but eroding the tax base of one country. Tax laws like India's Section 92 and similar provisions

worldwide empower authorities to **adjust non-arm's length transactions to arm's length terms** for tax calculations, counteracting any tax advantage that could have been obtained. In short, non-arm's length arrangements trigger regulatory scrutiny; if found not reflecting market value, tax authorities will recompute the profits as if the deal had occurred at arm's length.

In practical terms, an arm's length arrangement is the **normative standard** – it's how independent strangers would trade. Non-arm's length arrangements are the exception, acceptable in ordinary business only if they happen to coincide with market outcomes. If they don't (and often they do not), tax rules on transfer pricing kick in to **align the outcomes with arm's length results**. This protects **both tax fairness and economic efficiency**, ensuring that related parties do not gain an undue advantage over others by virtue of setting their own transfer prices.

Conclusion

In summary, arm's length pricing is a cornerstone of both domestic tax law (as exemplified by India's Section 92F definition) and international tax policy. It is grounded in the idea that **related companies should transact just as independent entities would**, thereby preventing manipulation of prices to dodge taxes and ensuring that profits are taxed where they are earned. The economic rationale lies in preserving market integrity and fair competition, while the legal rationale is to protect tax revenues and uphold agreements between nations to avoid tax base erosion. The principle's significance cannot be overstated – it underpins the global transfer pricing framework set by the OECD, creating a common standard that facilitates cross-border trade **without giving multinationals free rein to shift profits**. Through methods and regulations, tax authorities worldwide put the arm's length principle into practice, adjusting non-arm's length outcomes to reflect true value. Arm's length pricing thus promotes an equitable allocation of income for tax purposes and remains a fundamental doctrine in international taxation and corporate compliance

Methods for Determining Arm's Length Price under Section 92C/Rule 10B

Introduction: Under Indian transfer-pricing law, every international or specified domestic transaction between associated enterprises must be priced as if it were between unrelated parties – the **arm's length price (ALP)**. Section 92C(1) of the Income-tax Act, 1961 and Rule 10B of the Income-tax Rules, 1962 prescribe six methods for computing ALP:

- Comparable Uncontrolled Price (CUP) Method
- Resale Price Method (RPM)
- Cost Plus Method (CPM)
- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)
- **Other Method**

The taxpayer must choose the **most appropriate method** based on the transaction's nature, functions, assets and risks (FAR), and available data. In practice, this involves a detailed comparability analysis and may require adjustments for differences.

Below we explain each method's legal basis, principle, applicability, a narrative example, plus its pros/cons and common tax-authority views:-

1. *Comparable Uncontrolled Price (CUP) Method*

Legal definition: Section 92C(1)(a) lists CUP as an arm's-length method. Rule 10B(1)(a) elaborates that under CUP one "identifies the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction" and then adjusts for any material differences.

In essence, **CUP compares the controlled (related-party) price to a comparable uncontrolled price**, with adjustments as needed.

Core principle: CUP is the **most direct and reliable** approach if a true comparable exists. It directly benchmarks the related-party price against the market price in an independent transaction. If the goods/services and commercial terms are highly similar, any price difference

should be due to unrelated-party factors. Small differences (e.g. contract terms, geography, quality) are adjusted as per Rule 10B(1)(a)(ii).

In OECD terms, "CUP is the most direct and reliable measure of an ALP" when comparables are available.

Applicability: CUP is best used **when identical or very similar products/services are sold between related and unrelated parties in comparable circumstances**. Typical scenarios include bulk commodity sales, standard parts, or licensing of a mature patent without embedded intangibles. It works well when an **internal comparable** exists (the same seller also sells to an independent buyer under similar terms).

For example, if a subsidiary sells the same widget to both a third party and its own affiliate, those two prices can be compared directly. CUP is less suitable when products differ significantly, bundles of intangibles are transferred, or when reliable price data are scarce.

Illustrative narrative (case-style): A pharmaceutical group has two divisions. Division A (in India) imports active ingredients (APIs) from its multinational affiliate and sells finished drugs domestically. Division B (in Europe) buys identical APIs from an independent vendor and sells the same finished drugs in Europe. The local transfer price that Division A pays to the affiliate can be tested by comparing it to the price Division B paid to the independent supplier for the identical API. If Division B paid $10 per unit, and Division A paid $9.50, adjusting for minor differences (currency, timing) gives the ALP. If the adjusted independent price is $10.05, that price would be used as the arm's length price for Division A's import.This shows CUP in practice: the affiliate's transfer price is "benchmarked" to the third-party price.

Advantages:

- Direct market link: Uses actual market price as a yardstick, offering **high reliability** when comparables exist. It directly shows alignment with market conditions.
- OECD-preferred: Recognized as the preferred method under OECD guidelines. CUP reflects the true ALP if adjustments can be made accurately.
- Transparency: Provides strong evidence ("best evidence") to defend the transfer price to tax authorities, because it relies on real transactions.
- Simplicity (if available): When an almost identical product is sold in the open market, no complex profit allocations are needed; one compares prices.

Limitations and precautions:

- Finding comparables: Identical uncontrolled comparables are often hard to find. Even minor differences (product specs, volumes, payment terms, market) can make a price

non-comparable. For instance, a license deal attached to IP may not be a valid CUP for a bare product sale.

- Adjustment uncertainty: When adjustments for differences are large, the reliability of the benchmark falls. Substantial adjustments reduce accuracy.
- Tax authorities scrutinize the validity and quantification of such adjustments closely.
- Data sensitivity: If comparables are from publicly available (secret) sources, key details (quality, volume, contracts) may be missing, hindering accurate adjustment.
- Not always possible: If no clear price data exist (e.g. for highly customized services or proprietary intangibles), CUP may be infeasible.

Tax-authority observations and best practices: Indian tax authorities demand a rigorous **comparability analysis** under Rule 10B(3) when using CUP. This means documenting product similarity, functions performed, contractual terms, economic conditions, etc. Courts have emphasized that internal comparables (same seller different buyers) are strong evidence; external comparables must have very close FAR profiles.

For example, in Hughes Systique v. DCIT, the tribunal preferred an internal CUP where available. Assessing Officers often challenge CUP results by seeking hidden adjustments (e.g. removing an unreported bundled license). Best practice is to maintain robust documentation of both controlled and uncontrolled terms and to be prepared to explain any adjustments. Using CUP generally succeeds when all material conditions align or can be adjusted; otherwise a fallback method may be needed.

2. *Resale Price Method (RPM)*

Legal definition: Section 92C(1)(b) and Rule 10B(1)(b) define RPM. Rule 10B(1)(b) states: identify the **resale price** at which the tested party (the distributor) sells to an unrelated party; subtract a **normal gross margin** and related expenses to arrive at an ALP for the original purchase from the affiliate.

In formula form :

- RPM ALP = Resale Price to third party − (normal gross profit + selling expenses) + adjustments.

Core principle: RPM focuses on the **gross margin of the reseller**. It assumes that an independent reseller would earn a normal gross profit margin on the resale, and any excess after deducting that margin (and expenses) should represent the arm's length cost from the supplier. In other words, if the reseller's markup is in line with market, the remaining price must be fair. Under RPM, the "tested party" is usually the distributor or reseller with known resale price.

Applicability: RPM is best when one affiliate **buys from another and resells to third parties** with minimal value-addition. Typical scenarios are simple distribution arrangements (no IP or major service by distributor). It is most reliable if the reseller does not have significant intangible or unique functions. For example, an Indian subsidiary that only imports and sells a product without further manufacturing fits RPM. If the reseller adds substantial value, holds intangibles, or faces different risks than comparables, RPM is less appropriate.

Illustrative narrative: Consider **Sun Earth Distributors Pvt. Ltd.**, which buys solar panels from its wholly-owned parent abroad and sells them in India. Sun Earth sells the panels to Indian retailers (unrelated parties) at ₹ 50,000 each. Comparable independent distributors of identical panels earn a gross profit margin of 20% on their sales. Sun Earth's operating costs (sales commissions, logistics) on each panel are ₹2,000. Using RPM, we compute:

- Resale Price (SP) = ₹ 50,000.
- Arm's-length gross margin = 20% of ₹ 50,000 = ₹ 10,000 (based on comparables).
- Subtract distributor costs ₹ 2,000.
- Therefore, ALP (purchase price) = ₹ 50,000 − (₹ 10,000 + ₹ 2,000) = ₹ 38,000.

If SunEarth actually paid ₹ 36,000, this RPM result suggests it underpaid, and the ALP would be ₹ 38,000. Thus ₹ 2,000 might be added as a TP adjustment. This narrative shows how RPM "backs out" the wholesaler's margin to test the transfer price.

Advantages:

- Appropriate for distributors: Ensures the reseller earns an arm's-length gross margin, avoiding excess profits. It is straightforward when resale prices and costs are clear.
- Market-based: Relies on market-observed gross margin (unlike CPM which relies on cost). If independent distributors of the same goods have known margins, RPM uses real market data.
- Simplicity: With reliable comparables, calculations are easy (resale price minus margin). Often used in retail/distribution models where cost-plus is irrelevant.

Limitations and precautions:

- Need good comparables: Requires identifying comparable gross profit margins (from third-party resellers). Differences in business models can distort margins.
- Value-addition constraint: The tested party (reseller) should not perform significant R&D, marketing, or services – otherwise its margin will naturally be higher. If the reseller adds value beyond basic sales, RPM understates ALP.

- Single gross margin: RPM assumes a constant normal gross margin. In practice, gross margins vary with product mixes, geographic markets, and volume discounts.
- Multi-stage distribution: Complex supply chains (multiple distributors) may require RPM at multiple levels, complicating analysis.
- Adjustment complexity: As with CUP, adjustments for differences (e.g. warranty terms, credit periods) may be needed, which can be contentious.

Tax-authority observations and best practices: The Income Tax authorities look for a clear most appropriate method rationale. RPM is sometimes challenged if the distributor's role is not pure. For example, if the Indian reseller provides technical support or branding, the RBI might dispute use of RPM. Tax officials insist on comparable independent distributors to determine the normal gross margin, and they scrutinize any accounting differences. Best practice is to verify that the tested party is a **limited-risk distributor** (no intangibles, limited assets, simple functions) and to document comparable distributors' margins. Also, ensure that expenses considered are consistently defined and all relevant distribution costs are included. Proper documentation (Purchase Agreements, comparability report) is crucial.

3. Cost Plus Method (CPM)

Legal definition: Section 92C(1)(c) and Rule 10B(1)(c) define CPM. Rule 10B(1)(c) prescribes: determine the **direct and indirect costs** of production incurred by the supplier in the controlled transaction, then add a **normal gross profit markup** (based on comparables) to those costs. Formally:

- CPM ALP = (Direct + Indirect costs) + (Normal gross profit mark-up × costs) + adjustments.

Core principle: CPM assumes the supplier (tested party) should earn the same mark-up over cost as independent producers of similar goods/services. In practice, one computes the supplier's cost base (all manufacturing or service costs) and then applies a "cost-plus" margin from comparable uncontrolled transactions. The idea is that a fair price is cost plus an arm's-length profit.

Applicability: CPM is suitable when one affiliate **provides goods or services to its related party**, especially where the supplier is a contract manufacturer or service provider with measurable costs. Common examples include contract manufacturers or tolling arrangements, back-office service centers, or similar situations where the entity's contribution is primarily its cost. It is often used when the product does not include unique intangibles by the supplier (the value is in physical production). It is less suitable if the supplier owns valuable intangibles or if costs are not reliably allocated.

Illustrative narrative: Imagine **Alpha Manufacturing Pvt. Ltd.**, an Indian plant making electronic components for its foreign parent. Alpha's books show it spent ₹80 per unit (₹50 raw material +

₹ 20 labor + ₹ 10 overhead). Comparable independent manufacturers of this component typically earn a gross profit of 25% on cost. Using CPM:

- Cost per unit = ₹ 80.
- Normal gross profit = 25% of ₹ 80 = ₹ 20.
- ALP = ₹ 80 + ₹ 20 = ₹ 100.

If Alpha sold to the affiliate at ₹ 95, the TP adjustment would add ₹ 5 to reach ₹ 100. This treats ₹ 100 as the market-consistent price.

Advantages:

- Simple when costs known: If accurate cost accounting exists, computing a markup is straightforward. Manufacturers often have clear cost data.
- Good for routine suppliers: Suitable for contract manufacturers or suppliers with no special intangibles. By benchmarking mark-up, one ensures the supplier isn't undercharging.
- Abundance of comparables: Manufacturing or service providers often have many independent counterparts whose cost-plus mark-ups can be observed.

Limitations and precautions:

- Cost determination: Must reliably allocate all relevant costs. Disputes can arise over what constitutes "direct *vs* indirect costs", treatment of head-office overhead, interest, or taxes. For example, should land lease for the factory count? Any inconsistency in accounting methods between tested and comparable cases can distort the mark-up.
- Finding mark-ups: Requires comparables with similar functions and costs. Differences in scale or efficiency can make mark-ups non-comparable.
- Ignoring intangibles: If the supplier has valuable intangibles (like proprietary technology or brands), CPM may understate ALP because it ignores the intangible's value.
- Thin profit margins: In low-profit industries, slight cost differences can sway transfer price significantly.

Tax-authority observations and best practices: Revenue authorities frequently view CPM favorably for contract manufacturers. For instance, in DCIT v. Mahle Filters Systems India, CPM was upheld as MAM for a parts manufacturer. However, they will carefully examine cost allocation. It is best to preempt issues by using consistent accounting principles and clearly documenting cost calculations. TPOs often request breakdowns of costs and question any one-off or unusual items. For best practice, one should use a wide set of comparables and normalize their cost structures. Showing how the markup was derived (e.g. from a comparables

study) strengthens the position. Also, any inventory reserves or adjustments should be carefully handled, as such accounting choices affect the cost base.

4. Profit Split Method (PSM)

Legal definition: Section 92C(1)(d) and Rule 10B(1)(d) set out PSM. Rule 10B(1)(d) explains that PSM (often for unique intangibles or integrated transactions) involves: (i) determining the combined net profit of the related parties from the transaction, then (ii) splitting that profit between them based on their relative contributions (functions performed, assets used, risks assumed). The share allocated to the tested party is taken as its arm's-length profit.

Core principle: PSM is a **"combined profit" approach**. It is used when the value of the transaction comes from joint contributions (like co-developed technology) or when transactions are so interdependent that they can't be evaluated separately. There are two variants: **contribution analysis** (split based on estimated contributions) and **residual analysis** (allocate routine returns first, then split residual profits). In either case, PSM acknowledges that each party's actions affect the total profit, and allocates accordingly.

Applicability: PSM is most appropriate for highly integrated operations or unique, hard-to-value intangibles. Examples include joint R&D ventures, cross-licensing arrangements, or complex manufacturing networks where multiple affiliates contribute unique assets. It is also used when no single resale price or cost markup applies (e.g., two divisions jointly produce and market a product). Given its complexity, PSM is less common in practice and typically a fallback when CUP/RPM/CPM/TNMM cannot reliably capture value (for instance, after exhausting more direct methods).

Illustrative narrative: Suppose **BioGene India Ltd.** and its foreign parent co-develop a novel biotech drug. BioGene manufactures and markets it in Asia; the parent handles development and international marketing. The combined profit from the Asian sales is ₹100 crore. How to split it? Under PSM, they would assess the contributions: BioGene did manufacturing and local trials (asset use, local market knowledge), parent provided biotech patents and global sales network. Based on their FAR (e.g. R&D costs, risk, assets), an analysis might allocate 60% of profit to the parent and 40% to BioGene. Thus ₹40 crore is treated as BioGene's arm's length profit, implying a transfer price for BioGene's manufactured product that achieves ₹40 crore net profit. The parent's share would justify a license fee or equivalent transfer price component.

Advantages:

- Addresses unique intangibles: PSM can capture value of IP or brand where no direct comparables exist. It reflects each party's contribution to joint value.
- Holistic for integrated deals: Works when two related parties are so intertwined that separate transactional methods fail. It ensures that both sides share profits akin to how two independent firms might agree.

- Flexibility: Can incorporate economic indicators (sales, R&D spend) to approximate contributions.

Limitations and precautions:

- Data intensity: Requires detailed financials and an economic analysis of contributions. Often lacks clear external benchmarks for "split" percentages.
- Subjectivity: Apportioning profit based on FAR can involve judgment. Tax authorities scrutinize whether weights (e.g. weighting R&D vs marketing) are supportable by market evidence.
- Rarity: Because of complexity and lack of comparables, few Indian cases use PSM. TPOs and courts may prefer simpler methods.
- Documentation heavy: Must document combined profits and rationale for splitting (e.g. "Biotech R&D" vs "manufacturing value-add").

Tax-authority observations and best practices: Indian jurisprudence treats PSM with caution. The Board's Circular No. 6/2007 emphasizes that PSM should only be used when traditional methods are inapplicable (e.g. when transactions involve unique intangibles). In practice, tax authorities often insist on conservative splits (e.g. referencing comparable IPOs or industry splits). Best practices include performing a **preliminary test with other methods**: e.g. if reliable TNMM or CPM existed, why PSM? Only if those fail should PSM be adopted. If used, one should present a clear functional (FAR) analysis showing how contributions would be valued by independent firms, supported by market data (e.g. royalty rates, returns on intangibles). Indian cases (e.g. Honda Siel v. CIT) have allowed PSM where properly justified, but often demand an alternative method as cross-check.

5. Transactional Net Margin Method (TNMM)

Legal definition: Section 92C(1)(e) and Rule 10B(1)(e) prescribe TNMM. Rule 10B(1)(e) describes TNMM as computing the **net profit margin** of the tested party (relative to costs, sales or assets) in the controlled transaction and comparing it to the net margin of comparable uncontrolled transactions. The adjusted comparable net margin is then applied to the tested party's base to yield ALP.

Core principle: TNMM is a **profit-level indicator method**. Instead of pricing a specific product or service, it examines overall profitability. One selects a suitable base (such as costs, sales, or assets) and measures the tested party's net margin on that base. Then one finds independent companies (comparable in functions) and measures their net margin on the same base. If differences exist, adjustments (for scale, accounting policies, etc.) are made. Then the independent margin is used to compute what the tested party's profit should be, thereby setting the ALP.

Applicability: TNMM is the most widely used method in practice because it is flexible and often easier to apply. It is suitable when (a) detailed price or cost data are lacking for direct methods, but good data exist on net profitability of similar firms; (b) the tested party performs routine or standardized functions; or (c) the tested party has few or no comparables at price-level but many at net-margin level. For example, a simple distributor or toll manufacturer might use TNMM. It is less suitable when the tested party's net margin is heavily influenced by unique factors (e.g. a proprietary high-margin service).

Illustrative narrative: Consider **TechServ India Ltd.**, which provides standardized IT support services to its foreign affiliate. TechServ's net profit margin (net profit divided by total costs) is 5%. We find 20 independent Indian IT service companies of similar size and function; their average net margin is 6%. Before concluding, we adjust for differences: perhaps TechServ has slightly higher asset base, so we adjust downward to 5.8%. Using the adjusted 5.8% as arm's length, TechServ's revenue (or cost base) is then adjusted so that its net profit equals 5.8%. For example, if its costs were ₹ 100 crore, arm's length net profit should be ₹ 5.8 crore. If TechServ actually earned ₹ 4 crore, a TP adjustment of ₹ 1.8 crore may be made.

Advantages:

- Many comparables: Because net margins are easier to find than exact price or cost markups, TNMM often has a larger comparables pool.
- Less data needed: Requires only aggregate financials (P&L data) rather than detailed cost breakdowns or price lists.
- Widely accepted: Both taxpayers and authorities frequently use TNMM; e.g., the Indian Supreme Court in SABIC India upheld TNMM as a valid method when appropriate.
- Flexibility: Can use different bases (sales, costs, assets) to suit the business model.

Limitations and precautions:

- Weaker principle link: TNMM doesn't directly compare specific transactions, so it's considered a "last resort" by some. It may hide differences that price-level methods would catch.
- Base selection: Choosing the right profit level indicator (PLI) is critical. Using sales, assets or costs can yield different margins – one must justify the choice (consistent with how comparables are measured).
- One-sided: TNMM tests only one side (the tested party); if the other party's contribution is significant, TNMM may miss under-pricing or over-charging.
- Adjustments needed: Comparability adjustments (for scale, accounting methods, geographic risks) can be complex and reduce reliability.

Tax-authority observations and best practices: TNMM is very common in Indian TP audits. Authorities often prefer TNMM for routine distributors or service providers. However, they scrutinize the selection of tested party and comparables (e.g. whether the tested party is indeed the "lowest value-add" entity). In CIT v. SBC Industrial Products, the Supreme Court affirmed TNMM use. Authorities may require using operating margin or OP/EBIT as PLI rather than, say, net margin after extra-ordinary items. Best practices: use a large, reliable set of comparable companies (e.g. from public databases), ensure consistency of accounting policies (e.g. remove non-recurring items), and explain the PLI choice. Also, rule 10B(1)(e) requires adjusting comparable margins for differenceshostbooks.com, so document any financial adjustments made (currency, capacity utilization, etc.). It's wise to validate TNMM results against any available transactional methods (e.g. a rough check by RPM or CPM) as a reasonableness test.

6. Other Method (Method of Any Other Prescribed Method)

Legal definition: Section 92C(1)(f) provides for "such other method as may be prescribed by the Board", with Rule 10B(1)(f) referring to rule 10AB. In Indian law, this "Other Method" is often called the **MAM** (Most Appropriate Method) or **sixth method**. The principle is that if none of the five traditional methods can be applied reliably, the taxpayer or tax officer may devise any method that yields an arm's-length result consistent with the ALP principle (see Circular 6/2007 and legislative history).

Core principle: The Other Method is a flexible, residual approach. It usually comes into play for unique situations – for example, when transactions involve significant intangible elements for which no direct comparables exist. A common example is the **Berry Ratio** for limited-risk distributors: Berry Ratio = (Gross Profit) / (Operating Expenses). Under this, one ensures that gross profit covers operating expenses at an arm's-length rate. The Other Method can use any reasonable basis (subject to Board rules, e.g. Rule 10AB) that approximates what independent parties would have done. As HLS Advisors explains, the sixth method was introduced to "relax" strict CUP requirements and allow a hypothetical price to be applied.

Applicability: Other Method is truly a fallback. It is invoked when the five primary methods all fail to produce a reliable ALP. For instance, if a reseller has no suitable gross margin comparables and its net margins are also distorted, one might apply the Berry Ratio, treating operating expenses as a proxy for value creation. Another scenario: a novel contract where one party provides mixed (hard to value) intangibles may require a special apportionment rule. Use of MAM should be justified by showing why conventional methods are unsuitable. It is important to remember that courts have held "other method" is not inherently inferior; it can be used even if other methods exist, provided it produces a sound arm's length result.

Illustrative narrative: An Indian subsidiary **Global Ads India** provides marketing services to its foreign parent. The subsidiary has high operating costs (large staff, local ad spends) and sells only to the affiliate, so there is no resale price and no comparables for its net margin. Independent

marketing firms might price services based on hours or campaign results, but none are directly comparable to an intra-group service rate. In such a case, the company and tax officer agree to use the **Berry Ratio** as a practical test: they assume that a fair gross profit (fees charged minus direct costs) should be some multiple of operating expenses. If comparable Indian marketing agencies of similar profile have a Berry Ratio of, say, 1.2 (gross profit = 120% of expenses), then Global Ads' pricing is adjusted so that its gross profit to expenses equals ~1.2.

Similarly, the Delhi HC has noted that Berry ratio (OP/VAE) is an acceptable indicator under TNMM. Here, because standard RPM/CPM analysis was impossible, this "other method" serves to approximate an ALP.

Advantages:

- Flexibility: Can craft a method tailored to facts when others are not workable. For example, it allows using hypothetical or regulatory prices.
- Addresses gaps: Captures value of services or intangibles not captured by price/cost based methods.
- Jurisprudence acceptance: Courts in India have upheld Berry Ratio and similar approaches under the "other method" provision.

Limitations and precautions:

- No clear formula: Since it's ad hoc, it risks being arbitrary. The chosen method must be defensible.
- Burden of proof: The taxpayer must rigorously justify why standard methods fail and why the alternative accurately reflects arm's-length.
- Judicial scrutiny: Courts will examine if the alternative truly represents what independent parties would do. For example, the Delhi HC insisted Other Method only if others are inappropriate, though some decisions (Star India) say there's no fixed hierarchy.
- Complexity: Developing a hypothetical benchmark often requires creative analysis and can lead to disputes.

Tax-authority observations and best practices: Tax officers sometimes resort to MAM when, for example, a taxpayer insisted on TNMM but authorities believed CUP or RPM would yield a higher price. The HLS summary of a Delhi HC case shows the officer tried to apply MAM (using multiple commission agreements) after rejecting TNMM, but the tribunal and HC pushed back. A key lesson: if a method (TNMM, etc.) was accepted in prior years with similar facts, changing it later without cause is risky. Also, Berry Ratio and similar formulas are acceptable only with careful comparability analysis of which expenses constitute the base. Best practices: explicitly evaluate all prescribed methods first; use Other Method only with clear reasoning. If using Berry Ratio, ensure the ratio for comparables is well-supported (cite independent firms' financials), and carefully define "operating expenses." Document the hypothetical pricing assumptions and compare multiple scenarios to show consistency with the arm's-length principle.

Determination of Most Appropriate Method

The arm's length price shall be determined having regard to the most appropriate method. The most appropriate method shall be the method which is best suited to the facts and circumstances of each particular transaction, and which provides the most reliable measure of an arm's length price in relation to an international transaction.

1. The most appropriate method shall be selected having regard to the following, namely:

1. The nature and class of the international transaction.
2. The class or classes of associated enterprises entering into the transaction and the functions performed by them taking into consideration assets employed or risk assumed.
3. The availability, coverage and reliability of data necessary for application of the method.
4. The degree of comparability existing between the international transactions and the uncontrolled transactions and between the enterprises entering into such transactions.
5. The extent to which reliable and accurate adjustments can be made to account for differences, if any, between the transactions being compared and the enterprises entering into such transactions.
6. The nature, extent, and reliability of assumptions required to be made in application of a method.

In a case where the factors referred to above indicate more than one method as the most appropriate method, the method providing a result consistent with the result obtainable by application of a method other than such method may be taken as the most appropriate method.

However, in a given situation and to the extent possible, the Comparable Uncontrolled Price Method or the Resale Price Method or the Cost Plus Method shall be considered to be more appropriate than the Profit Split Method or the Transactional Net Margin Method.

If the Assessee wants to adopt a particular method to demonstrate that the international transaction in question is at arm's length, then it is its duty to maintain and furnish adequate required data. When the burden of proving that a particular method is the most appropriate method is initially on the Assessee, it is for the Assessee to demonstrate the same by furnishing adequate record and data, irrespective of the fact whether they are statutorily required or not.

Important Note :-

- **There is no particular order or priority of methods which the assessee must follow.** No method can invariably be considered to be more reliable than others.
- However, Transactional Profit Methods i.e. Transactional Net Margin Method and Profit Split Method are treated as methods of last resort which are pressed into service only when the other method cannot be reasonably applied.
- The OECD guidelines also recognize this approach.

Where more than one price is determined, where the application of the most appropriate method results in determination of more than one price, then the arm's length price shall be computed in accordance with the provisions given under Rule 10b and 10ca. These rules are discussed here under.

2. The Range Concept in Indian Transfer Pricing

The **range concept** in Indian transfer pricing provides a statistically grounded method for determining whether the price or margin of an international or specified domestic transaction lies within acceptable boundaries of the arm's length principle.

What Is the Range Concept?

Rather than relying on a single benchmark, Indian rules — specifically **Rule 10CA of the Income-tax Rules, 1962** — permit the use of an **interquartile range**, defined as the span between the **35th and 65th percentiles** of a set of comparable uncontrolled results. If the result of a tested transaction (price or profit margin) falls **within this range**, it is deemed to be at arm's length, and **no adjustment** is required. However, if the result falls **outside the range**, the **median** (50th percentile) of the dataset is used as the arm's length benchmark for determining the adjustment.

When Is the Range Concept Applicable?

The range concept is permitted only under the following conditions:

- **Applicable Methods**: It can be used with the following methods:
    - Comparable Uncontrolled Price (CUP)
    - Resale Price Method (RPM)
    - Cost Plus Method (CPM)
    - Transactional Net Margin Method (TNMM)

- **Minimum Number of Comparables**: The dataset must include at least **six or more** valid and reliable comparables after applying appropriate filters.
- **Data Type**:
    - For CUP: Only current year data is used.
    - For RPM, CPM, TNMM: Multiple-year data (up to three years) may be used to compute weighted averages.

If any of the above criteria are not met — for instance, fewer than six comparables remain after filtering, or the Profit Split Method or "Other Method" is applied — then the **range concept cannot be used**. In such cases, the **arithmetic mean** is typically applied instead.

Illustrative Example

Assume the tested party's operating margin is being benchmarked under TNMM using 7 comparable companies with the following profit margins (in ascending order):

5%, 7%, 8%, 10%, 12%, 14%, 15%

- **35th percentile**: Position = 7 × 0.35 = 2.45 → Round up to 3rd position → **8%**
- **65th percentile**: Position = 7 × 0.65 = 4.55 → Round up to 5th position → **12%**

So, the **arm's length range is 8% to 12%**.

- If the tested party's margin is **9.5%** → within the range → **no adjustment**.
- If the margin is **6%** → outside the range → it will be adjusted to the **median**, which is **10%** (4th value).

Key Takeaways

- The range concept introduces flexibility and statistical precision into transfer pricing evaluations.
- It recognizes natural variations in market data and avoids unnecessary adjustments when results fall within an objectively determined range.
- When applied correctly, it ensures fair and consistent benchmarking in line with global best practices.

3. When range cannot be used

The range concept **cannot** be applied if there are fewer than six comparable values (or if the method does not yield multiple comparable prices, e.g. profit split/unspecified method). In those cases, the law requires the ALP to be based on the **arithmetic mean** of the dataset. Rule 10CA(7) explicitly states that where the provisions of sub-rule (4) (the range rule) "are not

applicable," the arm's-length price shall be the arithmetic mean of all values in the dataset. This aligns with the first proviso to Section 92C(2) of the Income-tax Act, which provides that if the most appropriate method produces more than one price, "the arm's length price shall be taken to be the arithmetical mean of such prices". In effect, whenever the dataset is too small for a range, the ALP is computed as the simple average of the comparable prices or profit indicators. (If only one comparable price exists, that single price itself is the ALP.)

Tolerance Band for the Arithmetic Mean

Rule 10CA(7) (and the second proviso to Section 92C(2)) also provides a **tolerance band** around the arithmetic mean. The proviso states that if the actual transaction price is within a notified percentage (not exceeding 3%) of the computed ALP (arithmetic mean), then the **actual price is deemed to be at arm's length**. In other words, if the difference between the ALP (mean) and the actual price does not exceed the statutory tolerance, no adjustment is needed.

Importantly, the Central Government periodically notifies the exact tolerance percentage. As of AY 2025-26, the tolerance is **±1% for certain wholesale trading transactions** (meeting specified inventory and cost conditions) and **±3% for all other transactions**. Thus, if the related-party price falls within ±3% of the arithmetic mean ALP, it is accepted as the arm's-length price. (For wholesale trading, the band is ±1%.) If the deviation exceeds the notified band, then the computed arithmetic mean is taken as the ALP for adjustment purposes.

Legal Provisions

- **Section 92C(2), Income-tax Act, 1961:** The first proviso says that when the chosen transfer pricing method yields multiple ALP values, use their arithmetic mean as ALP. The second proviso (introduced by Finance Act 2011 and amended subsequently) provides that if the variation between the ALP so determined and the actual transaction price does not exceed a notified percentage (≤3%), the actual price is deemed ALP.
- **Rule 10CA(4), Income-tax Rules, 1962:** This rule establishes the arm's-length range (35th–65th percentile) when a dataset has six or more values. If sub-rule (4) applies, the ALP is determined by that range.
- **Rule 10CA(7):** This rule covers the "other cases" where Rule 10CA(4) does not apply. It mandates that the ALP be the arithmetic mean of the dataset. Its proviso (reflected in current CBDT notifications) sets the tolerance band (up to 3%) within which the actual price is deemed arm's length.
- **Notifications (e.g. 116/2024):** The CBDT notification (e.g. No. 116/2024 dated 18.10.2024) implements the tolerance: it specifies 1% for wholesale trading and 3% for others (FY 2024-25) under the proviso to Rule 10CA(7)pib.gov.in.

Example

- Setup: An Indian subsidiary applies the **TNMM** and identifies two comparable companies. Their operating-profit-to-cost ratios (OP/OC) are 10% and 14%. (Since there are fewer than 6 comparables, the range concept cannot be used.)
- Arithmetic mean: The arithmetic mean of the two PLIs is (10%+14%)/2 = **12%**. This 12% is the computed ALP margin.
- Actual transaction: The actual related-party transaction yields an OP/OC of **11.5%**. Compare this to 12%: the difference is 0.5 percentage point (i.e. ~4.17% of 12%). However, the tolerance band is ±3% of 12% (±0.36 percentage point), so 11.5% is 0.5% below 12%, which is **within the ±3% band** of the mean.
- Result: Because the actual margin (11.5%) lies within ±3% of the mean (12%), the transaction price is **deemed to be at arm's length**. In practical terms, if the operating cost were ₹100,000, the computed ALP profit would be ₹12,000 (12%), but the actual profit of ₹11,500 (11.5%) is accepted (since 11.5% is within the tolerance).
- If tolerance were exceeded: Suppose instead the actual margin was 15%. That would be +3 percentage points above 12% (exceeding ±3%). In that case, the arithmetic mean (12%) itself would be taken as the ALP (and the transaction price adjusted) rather than deeming 15% acceptable.

This example illustrates the rule: with fewer than six comparables, use the arithmetic mean ALP; then apply the notified tolerance (± 3% non-wholesale) to decide if the actual price can be accepted as ALP. If within the band, the actual price is taken as arm's length per law; otherwise, the mean ALP is used.

Summary of significant Indian jurisprudence on the determination of the Most Appropriate Method (MAM) in transfer pricing:

I. Consistency in Method Selection

Case: Principal CIT v. ABIC India Pvt. Ltd.

Court: Delhi High Court

Summary:

The court emphasized the importance of consistency in selecting the MAM. It held that the Transactional Net Margin Method (TNMM), consistently applied in previous years without any significant change in business operations, should not be arbitrarily replaced by another method without substantial justification.

II. Applicability of 'Other Method'

Case: **Star India Private Limited v. ACIT-16(1)**.

Tribunal: Mumbai ITAT (Special Bench)

Summary: The tribunal clarified that the 'Other Method' is not a method of last resort and can be considered alongside other prescribed methods. The selection should be based on the method's appropriateness to the transaction's nature and available data.

III. Rejection of TNMM Without Justification

Case: SABIC Innovative Plastics India Pvt. Ltd. v. ACIT

Court: Delhi High Court

Summary: The court held that the Transfer Pricing Officer (TPO) cannot reject the TNMM, especially when consistently applied in prior years, without providing substantial reasons. The TPO's adoption of the 'Other Method' was deemed unjustified due to inadequate comparables and lack of proper rationale. LinkedIn

IV. Use of Resale Price Method (RPM)

Case: PCIT Vs. Burberry India Pvt. Ltd.

Court: Delhi High Court

Summary: The court upheld the use of RPM as the MAM for a routine distributor importing and reselling goods without any value addition. It rejected the TPO's contention that high advertising expenses warranted a different method, emphasizing that such expenses alone do not change the functional profile.

V. Limitations of Applying MAP Outcomes

Case: AON Consulting Pvt. Ltd. v. PCIT

Court: Delhi High Court

Summary: The court ruled that Mutual Agreement Procedure (MAP) settlements are specific to the jurisdictions involved and cannot be unilaterally applied to transactions with entities from other countries. Each transaction must be assessed independently under domestic laws.

VI. High Court's Role in Transfer Pricing Disputes

Case: PCIT v. Softbrands India Pvt. Ltd.

Court: Karnataka High Court

Summary: The court held that the selection of comparables and MAM are factual determinations. Unless there is a substantial question of law or perversity in the tribunal's findings, the High Court should not interfere.

VII. Supreme Court on High Court's Jurisdiction

Case: PCIT v. SAP Labs India Pvt. Ltd.

Court: Supreme Court of India

Summary: The Supreme Court clarified that while High Courts generally should not interfere with factual determinations in transfer pricing, they can examine whether the guidelines under Chapter X of the Income Tax Act and corresponding rules were duly followed. If not, it could constitute a substantial question of law.

VIII. Use of Advance Pricing Agreements (APAs) for Non-APA Years

Case: PCIT Vs. Springer India Pvt. Ltd.

Court: Delhi High Court

Summary: The court allowed the use of an APA's terms for a non-APA year, provided the functional, asset, and risk (FAR) profiles remained consistent. This promotes consistency and reduces litigation.

IX. Applicability of Transfer Pricing to Exempt Income

Case: Doshi Accounting Services Pvt. Ltd. v. DCIT

Tribunal: Ahmedabad ITAT

Summary: The tribunal held that transfer pricing provisions apply even if the income is exempt under sections like 10A. The arm's length principle ensures accurate reporting and prevents profit shifting, regardless of tax exemptions.

X. Sham Transactions and Transfer Pricing

Case: Mitchell Drilling India Pvt. Ltd. v. DCIT

Tribunal: Delhi ITAT

Summary: The tribunal emphasized that transfer pricing provisions apply only to genuine transactions. If a transaction is found to be a sham, it falls outside the scope of transfer pricing regulations.

These cases collectively underscore the importance of consistency, proper justification, and adherence to statutory guidelines in determining the Most Appropriate Method in transfer pricing. They also delineate the boundaries of judicial intervention in such matters.

The Role and Importance of the OECD in Indian Transfer Pricing Regulations

Although India is not a member of the Organisation for Economic Co-operation and Development (OECD), the OECD's Transfer Pricing Guidelines and its broader policy initiatives—particularly through the Base Erosion and Profit Shifting (BEPS) project—have played a foundational and continuing role in shaping India's transfer pricing regime. The influence of OECD standards is evident in the legal framework, administrative practice, documentation requirements, dispute resolution mechanisms, and judicial interpretation under Indian tax law.

1. Normative Influence: Adoption of OECD-Based Principles

India's transfer pricing provisions, introduced in 2001 through Sections 92 to 92F of the Income-tax Act, 1961, were fundamentally modelled on the OECD Transfer Pricing Guidelines. The most significant aspect of this influence is the adoption of the **Arm's Length Principle (ALP)** as the cornerstone of India's international transfer pricing regime.

Further, the Indian rules explicitly recognize the five methods for determining the ALP, all of which are derived from the OECD Guidelines:

- Comparable Uncontrolled Price (CUP) Method
- Resale Price Method (RPM)
- Cost Plus Method (CPM)
- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)

Although Indian law allows the use of "any other method" (Rule 10AB), this too aligns with the OECD's flexible and substance-oriented approach to pricing complex or non-standard transactions.

2. Influence on Transfer Pricing Documentation and Compliance

India has adopted the OECD's **three-tiered documentation structure** recommended under **Action 13 of the BEPS project**. This includes:

- **Master File** (Rule 10DA): Provides group-wide information on global business operations, intangibles, and financial arrangements.
- **Local File**: Contains detailed information on specific cross-border transactions undertaken by the Indian entity.

- **Country-by-Country Report (CbCR)** (Rule 10DB): Requires large multinational enterprise (MNE) groups to disclose global income allocation, taxes paid, and business operations across jurisdictions.

These requirements are largely in conformity with OECD standards, which aim to enhance transparency and enable tax authorities to conduct risk-based assessments.

3. Alignment in Dispute Resolution Mechanisms

The OECD Guidelines have significantly shaped India's approach to resolving transfer pricing disputes through:

- **Mutual Agreement Procedure (MAP)** under Double Taxation Avoidance Agreements (DTAAs), which aligns with Article 25 of the OECD Model Tax Convention. MAP is particularly useful where a TP adjustment results in double taxation.
- **Advance Pricing Agreements (APAs)**: India's APA framework, introduced in 2012, closely mirrors OECD-recommended best practices. It allows taxpayers and tax authorities to agree on the transfer pricing methodology in advance, thereby providing certainty and reducing litigation.

Both MAP and APA practices reflect India's commitment to the OECD's cooperative dispute resolution norms.

4. Role in Judicial Interpretation

Indian courts and tribunals frequently refer to the OECD Transfer Pricing Guidelines while interpreting domestic transfer pricing provisions, particularly in the absence of specific Indian rules. While the OECD Guidelines are not binding, they are considered to be **persuasive authority** where consistent with Indian law.

5. Policy-Level Engagement and BEPS Implementation

India is a key participant in the **OECD/G20 Inclusive Framework on BEPS**, and has actively contributed to shaping several BEPS Actions, particularly those concerning:

- **Digital economy taxation** (Pillar One and Pillar Two proposals),
- **Combating treaty abuse** (Action 6),
- **Country-by-country reporting** (Action 13),
- **Limiting base erosion through interest deductions** (Action 4), which has influenced India's thin capitalization rules under Section 94B.

India's commitment to OECD-aligned BEPS outcomes is reflected in its domestic tax reforms and increasing efforts to balance revenue interests with global standards.

6. Convergence with Global Best Practices

The Indian transfer pricing regime, while retaining jurisdiction-specific provisions and enforcement practices (e.g., limited use of range concept, local preference for TNMM), has progressively moved toward **convergence with OECD best practices**, particularly in:

- Functional and risk analysis,
- Intangible valuation,
- Intra-group services,
- Treatment of cost-sharing arrangements.

This alignment facilitates cross-border consistency and enhances India's credibility as a tax jurisdiction in the global business environment.

Conclusion

The OECD, through its Transfer Pricing Guidelines and BEPS initiatives, has had a profound and lasting impact on India's transfer pricing framework. From the foundational adoption of the arm's length standard and prescribed methods to modern documentation norms and dispute resolution mechanisms, India's transfer pricing law reflects a high degree of alignment with OECD principles. This interconnection enhances cross-border tax transparency, reduces disputes, and promotes certainty and fairness in international taxation.

Synopsis of Transfer Pricing Compliances in India

Once an entity has selected its appropriate Transfer Pricing method, there are set compliance requirement governed by the Income-tax Act, 1961, and the Income-tax Rules, 1962. The objective is to ensure that international and specified domestic transactions between associated enterprises (AEs) are conducted at arm's length, thereby preventing profit shifting and base erosion.

1. Maintenance of Documentation

[Section 92D, Rule 10D]

- Every person entering into an international transaction or specified domestic transaction (above the prescribed threshold) is required to maintain detailed TP documentation.
- Documentation should include:
    - Group structure and business overview
    - Functional, asset, and risk (FAR) analysis
    - Economic analysis and benchmarking
    - Selection and justification of the most appropriate method (MAM)

2. Filing of Accountant's Report (Form 3CEB)

[Section 92E, Rule 10E]

- Mandatory for all taxpayers who have undertaken international or SDTs during the year.
- Form 3CEB must be filed electronically, duly certified by a Chartered Accountant.

3. Master File Compliance (Form 3CEAA & 3CEAB)

[Rule 10DA, Section 92D]

- Applicable to **constituents of an international group**.
- Consists of:

- **Part A**: Basic details of the group (required if international transactions > INR 50 crore).
- **Part B**: Detailed Master File (required if consolidated group revenue > INR 500 crore **and** international transactions > INR 50 crore).

Filing Due Date:

- Form 3CEAA: On or before the due date of filing return under Section 139(1).
- Form 3CEAB (intimation by CE): 30 days before 3CEAA filing.

4. Country-by-Country Reporting (CbCR) (Form 3CEAC to 3CEAE)

[Section 286, Rule 10DB]

- Applicable to international groups with **global consolidated revenue exceeding EUR 750 million** (approx. INR 6400 crore).
- Reporting entity may be an Indian parent or designated alternate entity.
- Includes data on income, taxes, employees, and assets across jurisdictions.

Filing Forms:

- **Form 3CEAC**: Notification by CE of group
- **Form 3CEAD**: Actual CbC report
- **Form 3CEAE**: Intimation of the designated reporting entity (if not Indian)

5. Specified Domestic Transactions (SDTs)

[Section 92BA]

- Includes transactions like payments to related parties under Section 40A(2)(b), allocation of expenses in profit-linked deduction units, etc.
- Applicable only if aggregate SDTs exceed **INR 20 crore**.

6. Audit Trail and Maintenance Period

- TP documentation must be maintained for **8 years** from the end of the relevant assessment year.
- Must be updated annually to reflect any material changes.

7. Penalties for Non-Compliance

Nature of Default	**Relevant Section**	**Penalty**
Failure to file Form 3CEB	Section 271BA	₹ 1,00,000
Failure to maintain documentation	Section 271AA(1)	2% of transaction value
Incorrect information	Section 271AA(1)	2% of transaction value
Failure to furnish Master File	Section 271AA(2)	₹ 5,00,000
Non-filing of CbCR	Section 271GB	₹ 5,000 – ₹ 50,000 per day
Adjustment to ALP leading to tax shortfall	Section 270A	50–200% of tax underreported

Conclusion

TP compliance in India involves a structured and multi-tiered reporting framework that mirrors international best practices as outlined by the OECD. Businesses engaged in cross-border or specified domestic transactions must proactively ensure timely filing, robust documentation, and accurate disclosures to mitigate litigation and penalty risks.

Note :

Please refer Booklet on Practical guide on Transfer Pricing Compliances for complete information in respect to all the compliances under Indian Transfer Pricing Regulations under The Income Tax Act, 1961.

Notes


Behind Every Successful Business Decision, there is always a CMA

THE INSTITUTE OF COST ACCOUNTANTS OF INDIA

www.icmai.in

Headquarters:
CMA Bhawan, 3, Institutional Area, Lodhi Road, New Delhi - 110003
Ph: 011-24622156

Kolkata Office:
CMA Bhawan, 12, Sudder Street, Kolkata - 700016
Ph: 033-40364743/40364735

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