STUDY NOTES · BASIC CONCEPT

What is Transfer Pricing? What is Arm length Principle? What is an Advance Pricing Agreement? Know Everything

Indian Economy

19 Oct 2026

What?

Transfer pricing is the price charged in a transaction between two related entities of the same group, such as a parent company and its foreign subsidiary. Tax law requires that price to match what independent parties would agree. That standard is called the arm's length principle (ALP).

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The subject matters because a large share of world trade happens inside multinational groups rather than between strangers. UNCTAD has long estimated that about a third of global trade is intra-firm, and about 80% runs through MNE value chains. When one group entity sells goods, licenses a brand, lends money or provides services to another, the price decides how much profit is taxed in each country.

An example shows the risk. An Indian subsidiary pays its parent in a low-tax country a royalty of 10% of sales, where independent firms would pay 2%. Indian taxable profit shrinks and the parent's lightly taxed profit grows, yet the group's total profit is unchanged. This profit shifting is the core of what the OECD calls Base Erosion and Profit Shifting (BEPS). Revenue losses from BEPS are estimated at USD 100–240 billion a year, about 4–10% of global corporate income tax revenue (OECD estimate, 2015).

Transfer pricing is not tax evasion in itself. Every related-party transaction needs a price, and most are set in good faith. The policy question is how to test that the price is fair to each country's tax base without double-taxing the same profit.

The arm's length principle

The arm's length principle says a related-party transaction should be priced as if the two parties were independent, dealing "at arm's length" under comparable conditions. Tax authorities may adjust profits if the related parties' conditions differ from what independent parties would have agreed.

Legal basis. The principle is set out in Article 9 (Associated Enterprises) of the OECD Model Tax Convention and the UN Model Convention, and India's tax treaties carry it too. The detailed guidance is in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (first issued 1979, consolidated 1995, latest edition 2022). The UN Practical Manual on Transfer Pricing for Developing Countries (2013, updated 2021) adapts it for developing economies, and India contributed a country chapter to it.

Why countries use it?

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- **Neutrality:** group firms and independent firms are taxed alike, so the tax system doesn't favour group structures.
- **Shared standard:** almost every country applies the same test, which lowers the risk of double taxation.
- **Workable:** it looks at real market prices rather than an abstract formula.

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Criticisms

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- **Comparables are scarce:** there may be no independent comparable for unique intangibles, integrated operations or digital services. Developing countries also lack local databases.
- **Synergy is ignored:** a multinational exists because integration creates value. Pricing each piece as if separate can leave "residual profit" that is easy to place in low-tax entities.
- **Cost and disputes:** documentation and litigation are expensive, and India has one of the largest stocks of transfer pricing disputes in the world.
- **Alternative proposals:** the ICRICT and many developing countries argue for formulary apportionment, which splits a group's global profit by sales, assets and employees, as US states and the EU's proposed BEFIT do. OECD Pillar One Amount A partly moved in this direction.

Associated enterprises. The principle applies only between associated enterprises, meaning entities linked by management, control or capital. Indian law adds specific tests, such as holding 26% or more of the voting power, or one enterprise advancing loans worth 51% or more of the other's total assets.

Methods of determining the arm's length price

Indian law prescribes six methods, mirroring the OECD Guidelines. The taxpayer must use the *most appropriate method* for the facts; there is no fixed hierarchy. The first three are "traditional transaction methods" and the next two are "transactional profit methods."

Method	What it compares	Best suited to	Example
Comparable Uncontrolled Price (CUP)	Price in the related-party deal vs price in a comparable independent deal	Commodities, interest on loans, standard royalties	Crude oil sold to the parent priced against the Brent benchmark
Resale Price Method (RPM)	Gross margin earned by a reseller vs margin of independent resellers	Distributors that buy from an affiliate and resell without much value addition	Indian distributor of a foreign parent's phones
Cost Plus Method (CPM)	Gross mark-up on direct and indirect costs vs mark-up of independent suppliers	Contract manufacturing, semi-finished goods, routine services	Contract manufacturer selling to its group at cost + 8%
Transactional Net Margin Method (TNMM)	Net operating margin on a base (cost, sales or assets) vs comparable companies	Most widely used in India; IT/ITeS, captive service centres, distributors	Captive software centre earning 15% on total cost
Profit Split Method (PSM)	Combined profit split by each party's relative contribution	Highly integrated operations, unique intangibles on both sides	Jointly developed drug patents
Other Method (Rule 10AB)	Any price that has been or would be charged between unrelated parties	Cases with no clear comparables, e.g. valuation reports or quotes	Share valuation, a third-party quotation

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Comparability analysis. Whichever method is used, the controlled transaction is compared on five factors:

1. Characteristics of the property or service.
2. Functions performed, assets used and risks assumed, known as the FAR analysis.
3. Contractual terms.
4. Economic circumstances, such as market, geography and business cycle.
5. Business strategies, such as market penetration.

Comparables are screened from databases such as Prowess and Capitaline in India. India uses an **arm's length range** of the 35th to 65th percentile when there are at least six comparables, and the arithmetic mean (with a ±3% tolerance, ±1% for wholesale traders) otherwise. Multiple-year data may be used for comparables.

Indian legal framework

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India introduced a full transfer pricing code in 2001 (Finance Act 2001), in Sections 92 to 92F of the Income-tax Act, 1961, with procedures in Rules 10A to 10THD. From 1 April 2026 the Income-tax Act, 2025 replaced the 1961 Act. The same provisions now sit in Chapter X (Sections 161–177), with the substance largely unchanged.

Provision	1961 Act	Income-tax Act, 2025
Income computed at arm's length price	Sec 92	Sec 161
Associated enterprise	Sec 92A	Sec 162
International transaction	Sec 92B	Sec 163
Specified domestic transaction	Sec 92BA	Sec 164
Determination of ALP (methods)	Sec 92C	Sec 165
Reference to Transfer Pricing Officer	Sec 92CA	Sec 166
Safe harbour rules	Sec 92CB	Sec 167
Advance pricing agreement	Sec 92CC, 92CD	Sec 168, 169
Secondary adjustment	Sec 92CE	Sec 170
Documentation	Sec 92D	Sec 171

Provision	1961 Act	Income-tax Act, 2025
Accountant's report (Form 3CEB)	Sec 92E	Sec 172
Definitions	Sec 92F	Sec 173
Interest limitation (thin capitalisation)	Sec 94B	Sec 177

The 2025 Act section numbers follow the published Chapter X order (Chapter X listing).

Key features

1. **Scope:** the rules cover *international transactions* between associated enterprises where at least one is a non-resident. Since 2012 they also cover *specified domestic transactions* above Rs 20 crore, such as transactions with tax-holiday units. The scope includes goods, services, intangibles, loans, guarantees, cost-sharing and business restructuring.
2. **One-way rule:** an adjustment can only increase Indian taxable income. Transfer pricing can never be used to reduce it.
3. **Transfer Pricing Officer (TPO):** the Assessing Officer refers risk-selected cases to a specialised TPO, who determines the ALP. Foreign companies and other eligible taxpayers can object to the draft order before the Dispute Resolution Panel (DRP). Appeals then go to the ITAT, the High Court and the Supreme Court.
4. **Documentation:** taxpayers keep transfer-pricing documentation (Rule 10D) if their international transactions exceed Rs 1 crore. They file an accountant's report (Form 3CEB). Large groups also file a Master File (Form 3CEAA) and Country-by-Country Report (Form 3CEAD) if consolidated revenue is at least Rs 6,400 crore (about EUR 750 million), in line with BEPS Action 13.
5. **Penalties:** these include 2% of the transaction value for not keeping or not furnishing documents, and 200% of tax for misreporting income.
6. **Secondary adjustment (2017):** where a primary adjustment exceeds Rs 1 crore, the excess cash left with the foreign AE must be brought back to India within 90 days. Otherwise it is treated as a loan, and interest is imputed on it.
7. **Thin capitalisation (2017):** interest paid to non-resident AEs above 30% of EBITDA is disallowed, under BEPS Action 4. It can be carried forward for 8 years.

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Certainty measures

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- **Advance Pricing Agreements (APA), since 2012:** the taxpayer and CBDT agree the method or price for up to 5 future years, with a 4-year rollback. APAs are unilateral, or bilateral and multilateral involving the treaty partner. The CBDT signed a record 219 APAs in FY 2025-26 (84 bilateral), taking the total to 1,034 since inception (CBDT press release).
- **Safe Harbour Rules, since 2013:** for notified transactions, the tax department accepts the price if the declared margin meets a set rate. The regime now covers 12 categories. The Finance Act 2026 merged the IT and ITeS segments into a single "Information Technology Services" category at 15.5% and raised eligibility from Rs 300 crore to Rs 2,000 crore (per the same release).
- **Multi-year (block) determination:** the Finance Act 2025 lets an ALP determined for one year be applied to the next two years for similar transactions, cutting repeated audits.
- **Mutual Agreement Procedure (MAP):** under Article 25 of tax treaties, the two countries' competent authorities negotiate to remove double taxation from an adjustment.

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Global developments: BEPS and the two pillars

The OECD/G20 BEPS Project (2013–2015) reshaped transfer pricing around one idea: **profits should be taxed where economic activity and value creation occur**, not where contracts or paper entities say they are. India took part as a G20 member, and more than 145 jurisdictions now sit in the Inclusive Framework.

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Digital economy. Digital firms can earn large profits in a market with little physical presence, which strains both the arm's length principle and the permanent establishment concept. India responded with the Equalisation Levy (2016) and the Significant Economic Presence rule (2018). It withdrew the 2% levy on e-commerce in 2024 and the 6% levy on online advertising from April 2025, partly in the context of the global Pillar One negotiations and trade talks.

Landmark Indian cases

Indian courts have repeatedly limited how far the tax department can stretch transfer pricing beyond actual income-generating transactions.

Case	Court, year	Issue	Holding
SAP Labs India v. ITO	Supreme Court, 2023	Can High Courts hear appeals on TP determinations?	Yes. A High Court can examine whether the ALP was determined according to the law and guidelines; the ITAT is not always final
Sony Ericsson Mobile Communications India v. CIT	Delhi HC, 2015	Whether excess advertising, marketing and promotion (AMP) spend builds the foreign parent's brand	Rejected the "bright-line test" for AMP; distribution and AMP functions may be bundled and benchmarked together
Maruti Suzuki India v. CIT	Delhi HC, 2015	Is AMP spend an international transaction when there is no agreement?	No. Without an arrangement with the AE, AMP spend cannot be presumed to be an international transaction
Vodafone India Services v. Union of India	Bombay HC, 2014	Shares issued to the parent allegedly below fair value	Share issue is a capital account receipt, not income, so TP adjustment does not apply. The government accepted the ruling in January 2015
Shell India Markets v. ACIT	Bombay HC, 2014	Same issue of share issue to the parent	Followed Vodafone: no income arises, so there is no TP adjustment
CIT v. EKL Appliances	Delhi HC, 2012	Can the TPO disregard or re-characterise an actual transaction?	Only in exceptional cases, such as a sham, consistent with the OECD Guidelines

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Lessons from these cases

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- Transfer pricing applies only where there is real *income* and a real *transaction*.
- Tax officers must respect the actual transaction unless it lacks commercial substance.
- Aggressive adjustments harmed India's investment image and led to the APA, safe harbour and dispute-reduction reforms after 2014.

Challenges and way forward

The arm's length principle remains the global standard, but India needs both revenue protection and investor certainty. Recent reforms lean towards certainty.

Challenges

- **Litigation:** a large backlog of TP disputes, slow MAP outcomes and divergent rulings across ITAT benches.
- **Comparables:** a shortage of reliable comparables for intangibles, digital services, captive R&D and financial transactions such as guarantees and cash pooling.
- **Valuation:** difficulty valuing intangibles such as brand, data and user networks under the arm's length principle.
- **Capacity:** limited specialist TPOs and economic analysts relative to India's large cross-border caseload.
- **Global uncertainty:** Amount A has stalled, Pillar Two has been diluted for US groups, and unilateral digital taxes are rising.

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Way forward

1. Widen safe harbours and Amount B-style simplified returns for routine functions such as GCCs, IT services and distribution, which frees TPO capacity for high-risk cases.
2. Speed up APAs and MAP, and use block determinations to stop the same issue being litigated year after year.
3. Build an Indian comparables database and adopt the OECD guidance on financial transactions and hard-to-value intangibles.
4. Use CbCR data for risk-based selection of cases instead of blanket scrutiny.
5. Take an active role in the Inclusive Framework and the UN Tax Convention negotiations (started 2024) to argue for market-country taxing rights.

UPSC relevance

Syllabus links: GS Paper III (Indian economy: taxation, FDI and investment climate); GS Paper II (international institutions: OECD, G20, UN).

Prelims facts to remember

- The arm's length principle comes from Article 9 of the OECD and UN Model Conventions.
- India's TP code was introduced by the Finance Act 2001, with APAs from 2012 and safe harbour from 2013.
- There are six methods: CUP, RPM, CPM, TNMM, PSM and Other.
- The CbCR threshold is EUR 750 million (about Rs 6,400 crore), and the Pillar Two minimum rate is 15%.
- Under the Income-tax Act, 2025, TP is in Chapter X (Sections 161–177), in force from 1 April 2026.

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