

## TRANSFER PRICING- GENERAL RULES OF COMPUTATION OF ALP

Kalyani Rathi\*  
Kabir Jaiswal\*\*

### Introduction to Transfer Pricing and Arm's Length Pricing

Payment of taxes has always been a bone of contention for businesses and their managements as every person, more or less, attempts to reduce their tax liabilities to the least possible figure. In order to evade taxes, organisations often indulge into practices that unlawfully facilitate them in doing so. One such practice is Transfer Pricing wherein associated enterprises tend to deal with each other at a lower rate than the actual market rate or sabotage a better profit-making-opportunity for the sake of such deal, for manipulating profits. Transfer pricing generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises.<sup>1</sup> It basically covers all the transactions essentially between associated enterprises that manipulate profits. Issue arises when such transactions take place among concerned companies which are subject to different tax-rates. In order to prevent revenue losses through some transactions, a condition of computing the prices at an Arm's Length has been imposed on several categories of transactions.

Some of the classic examples of manipulative and unacceptable Transfer Pricing in the business world are the incidents of Coca-Cola's IP transfer to its subsidiaries in different countries, Facebook's Intangible Asset transfer to Ireland, Medtronic's Intellectual Property transfer to global tax heavens.<sup>2</sup> These incidents or transfers attracted disputes between the respective entities and the tax authorities. The transactions covered under the ambit of Transfer Pricing cannot be defined in a one-liner definition. It is all inclusive of transactions of related or unrelated goods between associate enterprises which paves way for profit manipulations. Transfer pricing is actually setting up of deal-price while transacting in goods and services between associated entities within an enterprise and is as such not problematic unless the

---

\* Student, National Law University, Odisha, Cuttack.

\*\* Student, National University of Study and Research in Law, Ranchi.

<sup>1</sup> Guide to Transfer Pricing, The Institute of Company Secretaries, 1<sup>st</sup> ed. 2016.

<sup>2</sup> Shobhit Seth, *Transfer Pricing*, Investopedia <https://www.investopedia.com/terms/t/transfer-pricing.asp> accessed on 21 Apr, 2021.

transaction affects the ultimate tax payment regime of those companies individually. Need to regulate Transfer pricing arises only to ensure fair valuation of economic activities and no diversion of tax revenues from the jurisdiction of the government.<sup>3</sup> Location of the organisations becomes the defining factor as to whether such discriminate pricing is ultimately sabotaging the government's revenue or not. Associated organisations located in different nations are subject to different taxes and hence they may cut down their valid tax liabilities by unduly deducting the profits of an organisation which is subjected to higher tax rates. In the aforementioned example, company Y may get benefitted taxes if it is located in a country which applies higher tax rates because due to reduced profits, the nett income of the company will be reduced.

Such tax evasions cause undue loss to the revenues of the nations and therefore to prevent such evasions, certain safeguards have been listed down in the concerned statute. One of the viable solutions for regulating Transfer Pricing is Arm's Length Pricing (ALP). ALP is the regulated price at which enterprises deal in commodities and services and the price of such deals is truly determined by the market forces. It is the price which is unaffected by any connection or association between the dealing entities. For obtaining appropriate tax revenue, Transfer Pricing shall be regulated and determined as per ALP, that is to say that associated enterprises shall deal in a way as if the enterprises are not associated at all and are independent market players. No bias shall arise by the virtue of their being associated to each other. Determination of appropriate ALP requires attention towards intricacies and the thus determined ALP shall reflect a price which could be charged from any other independent enterprise functioning in the market. We can conclusively say that Transfer Pricing is an important factor determining the net profit figures of an enterprise, thereby affecting the taxable revenues. It must be regulated and monitored by the concerned accountable authorities, namely the Company Secretaries and the Principal Officers.<sup>4</sup> The authorities must ensure that the price is being regulated and calculated as per the respective provisions. Such safeguards would aid in supporting the entity as well as ensuring the right valuation of the national revenues at large.

---

<sup>3</sup> *ibid.*

<sup>4</sup> *Transfer Pricing*, Economics Online

[https://www.economicsonline.co.uk/Business\\_economics/Transfer\\_pricing.html](https://www.economicsonline.co.uk/Business_economics/Transfer_pricing.html) accessed on 21 Apr, 2021.

Due to the increasing number of Multinational companies, a need was felt for introducing a globally acceptable mechanism in India for determining just and equitable profits and taxes. In line of this, India's Finance Act of 2001 introduced sections 92 - 92F in the Income Tax Act, 1961. These sections brought in the law of Transfer Pricing in India including the detailed procedure of documenting it. Transfer Pricing was earlier limited to being applicable in a situation with at least one of the companies having been located in a foreign jurisdiction. But in 2012, the scope of regulations concerning Transfer Price was expanded and extended to certain genre of domestic transactions as well. Section 92B enumerated the concerned provisions in the IT Act and thereby aided the nation in capturing even that profit which was being manipulated via transfer to tax free or least-taxed zones from taxable or high-taxed zones, under the ambit of taxable revenue. This also covered the profit manipulations being carried on for tax deference via transfer from a profit-making company to a loss-making associated enterprise. The consequences of not computing the prices of these transfers at an Arm's Length can be disastrous. Some of the possible outcomes could be Erroneous evaluation of the Financial performance of an entity, Inexact valuation of the finished product in situations where the inappropriately transferred goods and services have been used to obtain the finished product, bearing penal provisions for breaching the existing legal provisions framed for restraining such prohibited activities. This could be explained better with an illustration.

### **Statutory Framework**

Arm's Length Pricing as such has been defined under section 92 F. Section 92F defines several terms out of which sub section (ii) defines ALP as "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"<sup>5</sup>. ALP is also defined under paragraph 1 of Article 9 of the OECD MC and the principle laid out in the UN Model has also been reiterated in the OECD Model Tax Convention and the OECD Guidelines as supplemented and amended.<sup>6</sup>

### **92 C (1)<sup>7</sup>**

The mode of computing Arm's Length Pricing, which applies to International Transactions and Specifies Domestic Transactions (combinedly referred to as 'concerned transactions')

---

<sup>5</sup> Income Tax Act 1961, s 92F ss (ii).

<sup>6</sup> UN Transfer Pricing Manual 2017.

<sup>7</sup> Income Tax Act 1961, s 92C ss 1.

throughout the document), has been listed down under section 92C. Though the Arm's Length Price is ultimately to be determined via the most appropriate formulae, there are certain conditions that need to be fulfilled before and while choosing the most appropriate method. As mandated by sub section 2, the ALP shall be determined by the 'Most Appropriate Method (MAM)' out of any of the methods listed under this section or prescribed by the Board.<sup>8</sup> The listed Methods are highlighted as under: "(a) Comparable Uncontrolled Price Method (CUP), (b) Resale Price Method (RPM), (c) Cost Plus Method (CPM), (d) Profit Split Method (PSM), (e) Transactional Net Margin Method (TNMM), (f) Other method as may be prescribed by the Board and provided in Rule 10AB."<sup>9</sup> Every Method has its own unique applicability standards which are defined under Rule 10B<sup>10</sup> of the Act.

### **92 C (2)<sup>11</sup> & 92 C (2A)<sup>12</sup>**

The Provisos to sub section 2 provide certain pre-conditions that are to be considered before straight away taking the lawfully ascertained ALP via the most suitable formula out of the aforementioned ones. The first proviso to the sub section provides that if more than one price is determined after choosing any one of these methods as the MAM, the final ALP shall be calculated as the 'Mean' (Arithmetical Mean) of such determined prices. This essentially means that while determining the ALP via the most appropriate method, if the result gives more than one output, then the final choice shall consist of a combination of both the values and this can be done by the means of an arithmetic mean.

The benefit of arithmetical mean provided in the first proviso is hurdled by sub section 2A<sup>13</sup> as the benefit ceases to be claimed in the situation listed under the sub section. The sub section states that if the actual price at which an International Transaction has taken place exceeds the ALP determined via arithmetical mean for that particular transaction by 5% or more, the concerned assesses shall not be eligible and entitled to exercise the option of using arithmetical mean.

The second proviso to sub section 2 enlists the situation wherein a Deemed ALP shall be taken into account instead of the one obtained via calculations. It shall be done in a situation wherein the determined ALP does not exceed the Actual price at which the concerned transaction has

---

<sup>8</sup> *ibid*, s 92C ss 2.

<sup>9</sup> Income (n7).

<sup>10</sup> Income Tax Act 1961, rule 10B.

<sup>11</sup> *ibid*, (n8).

<sup>12</sup> Income Tax Act 1961, s 92C ss 2A.

<sup>13</sup> *ibid*.

taken place by at least 3% of the latter. In such a case, the deemed ALP shall be the Actual price of the transaction instead of the one obtained via calculations. Nevertheless, calculation of ALP via the most appropriate method is a *sine qua non* even in this case. The decision has to be made after completion of the calculation and further comparison.

The third and last proviso to sub section 2 specifies the situation where the first two provisos shall not be applied. In a situation where the concerned transaction has been undertaken on or after 01<sup>st</sup> of April 2014 and more than one price is determined by ALP for such a transaction, the ALP shall be determined in the subjectively prescribed manner and the above two provisos shall not be applied to such a transaction. The two essentials popping out of the proviso are ‘date of transaction’ and determination of at least two prices by ALP’. If both the requisites are fulfilled, the first two provisos of the sub section shall be nullified for the purpose of such transaction in particular.

### **92 C (2) B<sup>14</sup>**

Sub sections 2B, 3 and 4 enlists the powers of an Assessing Officer with respect to determination of ALP in certain situations. Assessing Officer means “the Income-Tax Officer or Assistant Commissioner of Income-Tax or Deputy Commissioner of Income-Tax or Joint Commissioner of Income-Tax or Additional Commissioner of Income-Tax who is authorized by the Board to exercise or perform all or any of the powers and functions conferred on, or assigned to an AO under the Income tax Act, 1961”<sup>15</sup>. Sub section 2B limits the powers of an Assessing Officer to a certain extent. The section restrains the officer from enhancing the liability of an assessee by either “assessing or reassessing under section 147<sup>16</sup> or by passing an order enhancing the assessment or reducing a refund already made under section 154<sup>17</sup>” for a concerned assessment year whose proceedings have been completed before extending beyond 01<sup>st</sup> October 2009.

### **92 C (3)<sup>18</sup>**

Sub section 3 on the other hand empowers the Assessing Officer to proceed with the determination of ALP for the concerned transaction on the basis of his collected documents

---

<sup>14</sup> *ibid*, 92C ss 2B.

<sup>15</sup> Report number 07 of 2009-10, Performance Audit  
[https://cag.gov.in/uploads/download\\_audit\\_report/2009/Union\\_Performance\\_Direct\\_Tax\\_Income\\_Tax\\_Refund\\_7\\_2009\\_chapter\\_10\\_glossary.pdf](https://cag.gov.in/uploads/download_audit_report/2009/Union_Performance_Direct_Tax_Income_Tax_Refund_7_2009_chapter_10_glossary.pdf) accessed on 25 Apr, 2021.

<sup>16</sup> *ibid*, s 147.

<sup>17</sup> *ibid*, s 154.

<sup>18</sup> *ibid*, 92C ss 3.

acting as an evidence with respect to the four listed opinions that he might hold under the sub section. If the officer rightfully (based on proof) believes that “(a) the price charged or paid in the concerned transaction has not been determined in accordance with sub-sections (1) and (2); or (b) any information and document relating to a concerned transaction have not been kept and maintained by the assessee in accordance with the provisions contained in sub-section (1) of section 92D and the rules made in this behalf; or (c) the information or data used in computation of the arm's length price is not reliable or correct; or (d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D”<sup>19</sup>, he shall proceed with the options given under sub sections 1 and 2 along with the collected proofs and shall compute accordingly.

Proviso to this sub section casts a duty upon the assessing officer to issue a show cause notice to the assessee for presenting his perspective of the situation and for letting him object to the special proceeding taken under sub section 3.

### **92 C (4)<sup>20</sup>**

Sub section 4 read along with its first proviso gives an insight into the limitation put over the deductions that an assessee may claim over its income. The sub section allows the Assessing officer to compute the Total Income of an assessee with regard to the ALP so obtained under the previous sub section. Its combine reading with its proviso infers that the deductions available under Section 10A<sup>21</sup>, 10AA<sup>22</sup> and 10B<sup>23</sup> towards income shall not be available for such amount of income of the assessee which is increased after computation under this sub section. Elaborately, the difference between the previously computed income and the income computed having regard to ALP shall not be eligible for being considered while claiming deductions under the aforementioned sections.

---

<sup>19</sup> *ibid.*

<sup>20</sup> *ibid*, 92C ss 4.

<sup>21</sup> *ibid*, s 10A.

<sup>22</sup> *ibid*, s 10AA.

<sup>23</sup> *ibid*, s 10B.

**Johnson Matthey India (P) Ltd vs Department of Income Tax<sup>24</sup>**

The case was an appeal against the CIT's order dated November 26, 2009. Johnson Ltd. is the assessee in the present case and it indulged into an international transaction with its assessee company. On the basis of functional and risk profile and on examining the available comparable data, the Transactional Net Margin Method (TNMM) was determined to be the most appropriate method for determination of ALP. "Based on the search data for the financial year 2002-03, the return of Capital calculated on an average basis turned out to be lesser than what the appellant calculated. Appellant's value was 28.42% whereas the data calculation resulted into a value of 18.33%. Based on this, it was concluded by the appellant that the transaction was at Arm's Length. But the Transfer Pricing Officer's (TPO) computation of ALP varied substantially from that of the assessor's. Therefore, the assessee had to face a proceeding.

CIT decided the case while acknowledging Assessing Officer's (AO's) powers of computation under section 92C. CIT restricted the addition of Rs.8,33,86,859/- to Rs.7,03,05,000/- made by the AO on account of ALP. The assessee objected against the decision and pointed out certain specific objections in this appeal. The assessee claimed that the *application of section 92C(2) by the CIT was erroneous*. It has also raised question regarding the *treatment of 5% deduction under the section as a standard deduction* in this appeal. Apart from these contentions, the assessee pointed out several other contentions as well including the erroneous inclusion of Interest Income under Business Income, etc. For the purpose of this discussion, it is important to note that this appeal resultantly led the ITAT to discuss and interpret section 92C(2) of the Income Tax Act in detail. It is pertinent to highlight here that the TPO did not allow any benefit under the said section as in his view above provision was not applicable in this case. The provision would be applicable only if ALP shown by the taxpayer falls within 5% of arithmetic mean of more than one price determined by the Most Appropriate Method, and the Tax Payer here did not fall in this range.<sup>25</sup>

The essence of section 92C(2) read with its proviso was discussed in this appeal. While upholding the decision taken by the CIT, ITAP Delhi observed that "If the transfer price shown by the taxpayer was less than 5% in case of receipts or more than 5% in case of outgoings of

---

<sup>24</sup> (2010) ITA 344 Del.

<sup>25</sup> *ibid* at 11.

the arithmetical mean ALP determined by the AO, then the transfer price declared by the taxpayer was not to be accepted.”<sup>26</sup> That is to say that if the taxpayer’s value of Transfer Pricing did not fall within the 5% limit, the mean method of computing ALP could not be applied. For the second question, the ITAT rightly held that “In our considered view, the tolerance band provided in the aforesaid provision is not to be taken as a standard deduction. If the arithmetic mean falls within the tolerance band, then there should not be any ALP adjustment. If it exceeds the said tolerance band, then ALP adjustment is not required to be computed after allowing the deduction at 5%.”<sup>27</sup>

The case is important for the purpose of interpretation of section 92C(2). While majority of the contentions included issues with respect to the way of calculation, several brief pointers decided in the judgement were important for being memorised. Apart from that, an important setback pointed out by this case is the ambiguity in the computation provisions resulting in hardships for the assesses. Keeping aside the practices of fraud and forgery, the computation provisions do result into ambiguity at times. But judgements clarifying the stance are to be highlighted and so should this judgement be. This judgement rightfully clarified the manner of application of the concerned section. While the court followed CIT’s decision without providing much reasoning of its own, the CIT reasoned the case sufficiently to be fit for being properly construed.

### **Aztec Software and Technology vs Acit**<sup>28</sup>

A case with multiple questions and numerous answers, this case dealt with some of the most significant questions that might arise while computing ALP. The appeal was specifically made to ask several questions of Law. For the purpose of our discussion, the relevant question of Law asked in this appeal is “Whether it is a legal requirement under the provisions contained in Chapter X of the Income Tax Act, 1961 that the Assessing officer should prima facie demonstrate that any one or more of the circumstances set out in Clauses (a), (b), (c ) and/or (d) of Sub-section (3) of Section 92C of the said Act are satisfied in the case of any assessee, before his case is referred to the Transfer Pricing Officer under Sub-section (1) of Section 92CA for computation of the arm's length price?”<sup>29</sup>

---

<sup>26</sup> ibid at 11.

<sup>27</sup> ibid at 31.

<sup>28</sup> (2007) 107 ITD 141 Bang.

<sup>29</sup> ibid at 2.



Answering the question, the ITAT Bangalore here observed that the Assessing Officer, before exercising its power under section 92CA(1) by delegating the determination of ALP to the TPO, did not as such need to exhibit the overt existence of circumstances listed out under the clauses of section 92C(3). The tribunal also went on to observe that a reading of those provisions brought to notice that the AO could proceed to determine ALP by invoking these provisions in cases where he may either spot the existence of any of the circumstances mentioned under the clauses of 92C(3) or wherever he may find it necessary to delegate the process of determination of ALP to the Transfer Pricing Officer. The Assessing Officer as such need no other reason as the basis of invoking these provisions.

The case was again a clear case of ambiguity in interpreting the provision. But as rightly pointed out by the tribunal, a sincere reading of the provisions could provide a clear meaning to the provisions in this case. As rightly pointed out by the court, the proceedings under section 92C(3) of the act did not hold the proceedings under section 92CA(1) dependent on it. The possible reason for upholding so could be the fact that the time of introduction of both the provisions was different. By resolving several questions of Law, the aim of this judgement was to put forth a clearer stance of application of the ALP computation provisions. The judgement clearly succeeded in providing an extensive difference between 92C and other provisions, thereby clarifying the existing ambiguities to a certain extent.

### **Dcit, Circle - 11, Kolkata, ... vs Development Consultants Ltd.<sup>30</sup>**

The assessee company DCPL entered into international transactions with three of its associate enterprises. The kind of services exchanged in the transactions is provided not only to its associate enterprises but also to other parties by the assessee. DCPL thus used the internal Cost-Plus Method (CPM) to justify this class of international transaction. It is an established fact that the transaction took place at an Arm's Length. Since the assessee company has International transactions with the associated enterprises therefore, the Assessing Officer referred the matter to Transfer Pricing Officer, u/s, 92 of the Income Tax Act. The TPO suggested several changes in the value of ALP. The difference essentially arose due to variation in the manner of calculating the numerous transactions together. While the TPO suggested an increase in the total income computation, the assessee resisted the change and there lies this appeal.

---

<sup>30</sup> (2017) ITAT Kol.

The assessee pointed out that the method adopted by CIT was neither falling under RPM method nor under CPM method, which were the two closest options for the most appropriate methods. The tribunal then pointed out that CIT has no explanation to provide for the kind of method it has used for calculation. There was clearly an ambiguity overtly visible with respect to computation method. The CIT basically chose to compute jointly whereas the assessee chose to do it severally. This needed to be clarified at the earliest for resisting any such ambiguities in future. The tribunal therefore observed that “where an assessee has entered into various types of international transactions basis with associated enterprises, arm’s length price should be determined on a transaction-by-transaction basis not on an aggregate basis.”<sup>31</sup> This was one of the most land mark clarifiers among all the judgements that seek to clear interpretative and application-based ambiguities.

Further with respect to clarifying that no method of computation of ALP is superior to another, the case of **Serdia Pharmaceuticals (India) (P.) Ltd. V. CIT**<sup>32</sup> was the greatest lead. It bravely clarified that there shall be no order of superiority as such among the provided methods of computing ALP. The most appropriate method shall be chosen without keeping any priority list in consideration. Furthermore, another important judgement was **UOI v. A Sanyasi Rao**<sup>33</sup> which provided a clarification that is important for the overall understanding of computation as such. The judgement provided that the word Income is inclusive of Losses as well. Therefore, losses incurred by an assessee shall also form a negative part of its computable income. That is to say, while computing the income of an assessee under the Income Tax Act, the assessee is entitled to claim the losses that it has incurred for accruing such income.

### **Points to Remember**

- Rule 10AB, 10B and 10C of the Income Tax Rules provide furtherance to the general rules of computation of ALP stated under section 92C.
- Income includes losses and it will be net of expenses
- 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.

---

<sup>31</sup> *ibid.*

<sup>32</sup> (2011) 44 SOT 391 Mum.

<sup>33</sup> (1996) 219 ITR 330(SC).

- Where an assessee has entered into various types of international transactions basis with associated enterprises, arm's length price should be determined on a transaction-by-transaction basis not on an aggregate basis.
- If an international transaction includes only outgoings such as expenses, interest, allowances or other then these are also decided or valued on the basis of Arm's Length Price.<sup>34</sup>
- Section 92 is not applicable to a Non-resident whose income is not taxable as per provisions sections 5 and 9 of the Income Tax Act, 1961.
- Leverage of 5% under section 92C(2) is not to be treated as a standard deduction.
- Calculation of ALP via mean method is subject to the 5% limit rule stated under sub section 2A.

---

<sup>34</sup> Income Tax Act 1961, s 92(1).