

TRANSFER PRICING

A Comprehensive Guide for
Founders, CFOs and Startups

May 2025

Foreword

In today's hyper-connected global economy, businesses of all sizes increasingly operate across multiple jurisdictions, navigating a complex web of tax laws and regulatory frameworks. Transfer pricing—the pricing of transactions between related entities within a multinational enterprise—has emerged as a critical focus area for tax authorities worldwide. Its significance is heightened by the ongoing global efforts to curb tax avoidance through initiatives such as the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan.

For startups and growing companies, transfer pricing may initially seem like a challenge reserved for large multinational corporations. However, with the rapid pace of international expansion and the rise of digital business models, understanding and effectively managing transfer pricing is essential even for smaller enterprises. A sound transfer pricing strategy not only ensures compliance but also supports tax efficiency, operational transparency, and strategic business planning.

This guide provides a comprehensive overview of transfer pricing, fundamental concepts such as the Arm's Length Principle, transfer pricing methods and their application. Readers will gain insights into both global frameworks like the OECD guidelines and India-specific regulations, including documentation and compliance requirements. The guide also addresses common challenges faced by businesses, offers best practices for effective transfer pricing management, and presents real-world case studies to illustrate practical implications.

This comprehensive guide is designed specifically for founders, CFOs, finance teams, and other key stakeholders, to equip readers with the knowledge to navigate transfer pricing complexities confidently and align their strategies with regulatory expectations as they expand internationally.

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Introduction

What is Transfer Pricing?

Transfer pricing refers to the rules and methods used to determine the prices at which goods, services, or intangible assets are exchanged between related entities within a multinational enterprise (MNE).

In simpler terms, transfer pricing is the price one company charges another company within the same corporate group for goods, services, or the use of intellectual property like patents or trademarks. Imagine a large company that operates in several countries — for example, a technology company with branches in the U.S., India, and Germany. When the branch in the U.S. sells software to the branch in India, the amount it charges for that software is the “transfer price.”

These prices are very important because they determine how much profit each branch reports in its own country, which in turn affects how much tax the company pays in each location. If the U.S. branch charges too little, then the Indian branch will report more profit and pay more tax in India; if it charges too much, profits—and tax payments—may shift to the U.S. branch instead. This is why setting the right transfer price is essential to make sure taxes are paid fairly and according to where the actual business value is created.

To understand just how big an impact transfer pricing has on global trade, consider this: **research shows that more than 60% of international trade is actually between related companies within multinational corporations, not between independent companies.**¹ This means transfer pricing rules influence the pricing of a large chunk of world trade, affecting the economies and tax revenues of many countries.

Why is Transfer Pricing important?

Transfer pricing plays a crucial role in how multinational companies manage their global tax liabilities. If transfer prices are not set correctly, companies may face **tax audits**, hefty **penalties**, and potentially **double taxation**, where the same profits are taxed by both countries involved. On the flip side, if transfer prices are manipulated to shift profits from high-tax jurisdictions to low-tax jurisdictions, tax authorities in high-tax countries may challenge the pricing and adjust it, leading to additional taxes and penalties.

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<https://www.pwc.co.tz/press-room/transfer-pricing.html#:~:text=Globalisation%20and%20specialisation%20are%20some.as%20the%20%E2%80%9Cselling%20price%E2%80%9D%20that>

Additionally, transfer pricing is a key focus area in the **OECD's Base Erosion and Profit Shifting (BEPS) Action Plan**, a global initiative endorsed by OECD member countries to tackle tax avoidance strategies that exploit gaps and mismatches in tax rules. The BEPS project includes specific actions aimed at strengthening transfer pricing rules and improving transparency, ensuring that profits are taxed where economic activities and value creation occur. This global cooperation has increased scrutiny on transfer pricing arrangements and raised the bar for compliance worldwide.

For startups, the stakes are high, even if the business is smaller or in its early stages. Many startups expand globally early in their lifecycle, whether by setting up subsidiaries in foreign markets or licensing intellectual property (IP) to international affiliates. This makes it **critical to set fair transfer prices** for intercompany transactions, ensuring both **compliance with international and local regulations** and **tax efficiency**.

Relevance for startups and SMEs

While large multinational enterprises (MNEs) are often the focus of transfer pricing regulations, **startups and small-to-medium enterprises (SMEs)** should also pay close attention. If your business has subsidiaries or affiliates in multiple countries, or even within different states, you must **set and justify transfer prices** for any intercompany transactions. For example, a startup based in the **U.S. with a development subsidiary in India** or a **technology company expanding into the European market** will need to set prices for services, products, or royalties transferred between these entities.

Even for domestic transactions between related entities, such as between parent and subsidiary companies in India, transfer pricing rules may apply—**particularly where one of the entities is claiming a tax holiday or other tax incentives**, and the volume of transactions exceeds specified thresholds. For startups planning to scale internationally, addressing transfer pricing concerns early on will save significant time and money, helping you **avoid costly tax audits** and **legal disputes** later.

Fundamentals of Transfer Pricing

What are Intercompany Transactions?

Transfer pricing regulations are primarily applicable to **International Transactions** and, in some cases, **Specified Domestic Transactions (SDT)** as defined under the **Income Tax Act, 1961**. While international transactions constitute the majority of transfer pricing cases, specified domestic transactions are also covered when they meet certain criteria.

However, in practice, most transfer pricing regulations and compliance requirements primarily revolve around **international transactions** between related entities. This is because the core concern for tax authorities is to ensure that profits are fairly reported in the appropriate jurisdiction, thereby preventing tax base erosion through cross-border transactions.

Specified domestic transactions, on the other hand, are less commonly applicable and typically arise when transactions between related parties within India exceed the prescribed monetary threshold, or when one of the entities involved is claiming a **tax holiday** or other specified tax benefits.

In essence, for most practical purposes, businesses should focus primarily on **international transfer pricing compliance**, while keeping in mind the conditions under which specified domestic transactions might also trigger compliance requirements.

Introducing Arm's Length Principle (ALP)

The internationally accepted cornerstone of transfer pricing is the **Arm's Length Principle**. Simply put, the ALP states that **the price and terms of a transaction between related parties should be the same as if the parties were unrelated and acting at "arm's length"**.²

In other words, no special preference or distortion just because the companies are under common ownership. If Company A sells a product to its affiliate Company B, the price should be comparable to what Company A would charge an outside customer for a similar product under similar conditions.

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<https://tax.thomsonreuters.com/blog/transfer-pricing-documentation-by-country/#:~:text=The%20arm%E2%80%99s%20length%20principle%20states,while%20multinationals%20avoid%20double%20taxation>

This principle is enshrined in **Article 9 of the OECD Model Tax Convention** and has been adopted into national laws worldwide. The reason the arm's length standard is so crucial is to prevent companies from **manipulating profits** – for example, shifting profits to a tax-haven subsidiary by undercharging for goods, thereby minimizing income in a high-tax country. Tax authorities have the right to **adjust intragroup prices that deviate from arm's length** to ensure each country gets its fair share of tax. Applying ALP requires a **comparability analysis**: comparing the controlled transaction (between related companies) with transactions between independent companies to see if the terms are comparable. Factors like the functions performed by each party, risks assumed, assets used, contractual terms, economic conditions, and business strategies are examined to determine if differences exist that would affect prices. If a related-party price is out of line with what independent firms would agree to, an adjustment may be warranted. The goal is not only to prevent tax avoidance but also to ensure **no double taxation**, by aligning each entity's reported profit with value created.

Why does ALP matter for startups?

For a startup founder, ALP might sound technical, but it boils down to fairness and documentation. If your US parent company pays its Indian subsidiary for development services, you need to justify that the payment is neither too low (depriving the India unit of income) nor too high (depriving the US of income) compared to market rates for similar services. **Regulators worldwide have embraced ALP as the standard**, so understanding this principle helps you set up intercompany agreements correctly from the start. It's far easier to price things right initially than to face an auditor asking two years later why you charged \$5 million for something an independent firm would do for \$2 million.

Transfer Pricing Methods

How do we determine if an intercompany price is at arm's length?

The OECD Transfer Pricing Guidelines (followed by most countries) outline five primary methods to test and justify transfer prices.³ These methods are essentially tools to compare controlled transactions with independent benchmarks. They are broadly grouped into **(a) Traditional Transaction Methods** (which look at the pricing of a specific transaction) and **(b) Transactional Profit Methods** (which look at profit outcomes). Each method has its uses, and the choice depends on the nature of the transaction and data available. Below are the key methods and when to apply them:

S. No.	Method	Meaning	Usage	Pros/Cons
1.	Comparable Uncontrolled Price (CUP) Method	Compares the price charged in a related-party transaction to the price charged in a similar transaction between independent parties.	Used when reliable comparable transactions exist between independent parties.	<p>Pros: Direct market-based comparison, high reliability.</p> <p>Cons: Hard to find perfect comparables, less suitable for unique products/services.</p>
2.	Resale Price Method (RPM)	Starts with the resale price to an independent customer and subtracts an appropriate gross margin to arrive at the transfer price.	Applied mainly for distributors or resellers who add limited value to the product.	<p>Pros: Simple and effective for distribution.</p> <p>Cons: Less accurate if reseller adds significant value or market conditions vary.</p>
3.	Cost Plus Method (CPM)	Adds a reasonable markup to the costs incurred by the supplier of goods or services to determine the transfer price.	Used for contract manufacturers or service providers with clear cost bases.	<p>Pros: Easy to apply with clear cost data.</p> <p>Cons: May be unreliable if comparable costs differ significantly or if markup is hard to benchmark.</p>

S. No.	Method	Meaning	Usage	Pros/Cons
4.	Transactional Net Margin Method (TNMM)	Compares the net profit margin of the related-party transaction with margins of independent companies under similar circumstances.	Widely used when exact comparable prices are unavailable but profit margins are accessible.	<p>Pros: Flexible, broad applicability.</p> <p>Cons: Less precise for individual transactions, depends heavily on profit level indicators chosen.</p>
5.	Profit Split Method (PSM)	Splits combined profits from related-party transactions among entities based on their relative contributions to value creation.	Used for highly integrated transactions or when both parties make significant unique contributions.	<p>Pros: Suitable for complex, unique arrangements.</p> <p>Cons: Complex and subjective to allocate profits accurately, requires detailed functional analysis.</p>

Transfer pricing methods across traditional and profit-focused spectrums.



Global and India-Specific Transfer Pricing Regulations

What are Global standards (OECD guidelines)?

Transfer pricing is a global issue, and over 120 jurisdictions have introduced transfer pricing rules influenced by the **OECD (Organisation for Economic Co-operation and Development) Guidelines**.⁴ The OECD Transfer Pricing Guidelines provide a common framework for applying the arm's length principle and the methods described above. Most countries' domestic laws on transfer pricing echo these guidelines, ensuring some consistency across borders. The **OECD's Base Erosion and Profit Shifting (BEPS) project** in 2013–2015 further tightened the norms – notably **BEPS Action 13**, which introduced a standardized **three-tier documentation** requirement (Country-by-Country Report, Master File, and Local File) to enhance transparency. In essence, internationally **best practice** means: transactions with related parties should be documented and justified under ALP, and multinationals should disclose their global allocation of income, taxes, and business activities via CbC reporting (typically required for very large groups with revenues above €750 million). Tax treaties and forums like the EU and UN also endorse similar principles. For businesses, this means if you operate in multiple countries, you'll likely encounter very similar transfer pricing expectations – **benchmark your transactions, choose an OECD-recognized method, and maintain documentation** – regardless of whether you're dealing with the IRS in the US, HMRC in the UK, or the ITD in India.

India's Transfer Pricing Regulations

India has a well-defined transfer pricing regime under the **Income Tax Act, 1961**, largely aligned with OECD norms but with its own specifics. The modern TP law in India was introduced by the Finance Act, 2001, which inserted **Sections 92A to 92F** into the Income Tax Act. These provisions, effective from FY 2002–03, require that any income from an "international transaction" between associated enterprises (AEs) be computed having regard to the arm's length price. Key points of India's framework include:

- **Scope:** Initially, the rules applied to **cross-border transactions** between an Indian entity and its foreign associate. Since 2013, certain large domestic related-party transactions (referred to as "specified domestic transactions") are also covered, to prevent tax arbitrage within India. In practice, if two Indian entities are under

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https://www.ey.com/en_gl/technical/tax-guides/worldwide-transfer-pricing-reference-guide#:~:text=Worldwide%20Transfer%20Pricing%20Reference%20Guide,an%20overview%20for%20the

common control and one of them enjoys a tax holiday or special rates, their transactions above a threshold also need to be arm's length to prevent shifting of profits from taxable to non-taxable entities.

- **Associated Enterprises definition:** Section 92A lays out what constitutes AEs – essentially one enterprise participating in management, control or capital of the other, or common control criteria (like one entity holds >26% voting rights in the other, substantial loan dependency, majority of board in common, etc.). This definition is broad and can even rope in entities with de facto control beyond shareholding thresholds.
- **Methods and compliance:** Section 92C and Rule 10B prescribe the five methods (CUP, RPM, Cost Plus, TNMM, Profit Split, and even allow other “such method” if justified). Taxpayers must select the **most appropriate method** and compute arm's length prices accordingly. If the declared transfer price differs from arm's length, the tax officer can adjust the income. Importantly, **India places the onus on the taxpayer to maintain documentation** to substantiate their transfer pricing.
- **Documentation requirements:** Section 92D of the Act and Rule 10D of the Income Tax Rules detail the extensive documentation to be maintained. This includes an overview of the company and group, description of transactions, contracts, a **functional analysis** (functions performed, assets used, risks assumed by each party), economic analysis including selection of method and comparables, and financial details of comparables. In India, **maintaining a Local File (detailed TP Study report)** is mandatory if the aggregate value of international transactions exceeds ₹10 million (1 crore) in a year. This report is not automatically filed with authorities, but must be ready by the due date of filing the return and submitted on demand during assessment.
- **Accountant's report:** Additionally, **Form 3CEB**, an independent auditor's certificate, must be filed by all companies entering international transactions, by the due date (currently 30th November following the financial year). This assures the tax department that an accountant has examined the records and found them in order. Not filing this report incurs a penalty of ₹100,000.
- **Master File and CbC reporting:** Post BEPS, India implemented **Master File and Country-by-Country (CbC) reporting requirements in 2017**. The Master File (Rules 10DA) provides a high-level view of the multinational group's global business, transfer pricing policies, and allocation of income and activities. It is required if the

group's consolidated revenue exceeds ₹500 crore and the Indian entity's international transactions exceed ₹50 crore (or ₹10 crore for intangibles).⁵ The CbC Report (Section 286) is required for the ultimate parent of an MNE group resident in India (or alternate reporting entity) with consolidated group revenue ≥ ₹5,500 crore (approx EUR 750 million). The CbC report is filed in Form 3CEAD and provides country-wise aggregate info on revenue, profit, taxes, employees, assets, etc., to help tax authorities assess risk.⁶ These additions mean even startups that grow into large multinational groups will face these higher-tier reporting once they cross the thresholds.

- **Penalties and enforcement:** India's penalties for transfer pricing non-compliance are stringent. For instance, not maintaining documentation or not reporting a transaction in the accountant's report can lead to a **penalty of 2% of the value of that transaction**. Under-reporting income due to wrong transfer pricing can attract a penalty of 50% of the tax on the adjusted amount (and 200% in cases of deliberate misreporting). The combination of mandatory audits (Form 3CEB) and strict penalties has made Indian businesses very cautious. Mechanisms like **Advance Pricing Agreements (APAs)** (introduced in 2012) and dispute resolution through Mutual Agreement Procedures (MAP) are now helping provide certainty and resolve double-taxation cases.

Other countries

Most other countries have similar rules: local file documentation thresholds, penalties for non-compliance, and some form of disclosure in tax returns. For example, the U.S. follows Section 482 of the IRS Code (arm's length standard) and can impose penalties (20% or 40% of underpaid tax) if mispricing exceeds certain tolerances. Europe, China, Australia, etc., all have TP documentation laws aligning with OECD's template, sometimes with local nuances. The key takeaway for a finance team is that **wherever you expand, you should expect to deal with transfer pricing regulations**. Always check local requirements – e.g., do you need to file a specific form or documentation annually, are there local safe harbor rules (some countries offer simplified safe harbor margins for routine activities), etc. Being compliant in one jurisdiction doesn't automatically cover others, but a coherent global transfer pricing policy will be the foundation.

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<https://tax.thomsonreuters.com/blog/india-issues-final-rules-on-master-file-and-country-by-country-report-requirements/#:~:text=CbC%20report%20in%20Form%203CEAD>

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<https://tax.thomsonreuters.com/blog/india-issues-final-rules-on-master-file-and-country-by-country-report-requirements/#:~:text=India%20has%20implemented%20the%20C2%A0OECD%20BEPS,it%20is%20incorporated%20%2F%20organized>

Challenges in Transfer Pricing

Transfer pricing is often cited as one of the most complex areas of international tax, and businesses (large and small) face several challenges in this realm:

- Finding Reliable Comparables:** Implementing the arm's length principle hinges on comparing to independent benchmarks. **Obtaining good comparables data is notoriously difficult.** Companies may operate unique business models or sell unique products for which there are no obvious external benchmarks. Even when potential comparables are found, differences in scale, geographic markets, or accounting standards can require many adjustments. For example, a SaaS startup in India charging its US parent for development services might struggle to find publicly available financial data on truly similar companies to benchmark a profit margin. Databases exist and are widely used, but ensuring the comparability (and defending it to an auditor) is an art as much as science. This challenge is amplified for transactions involving **intangibles (like patents or trademarks)** because by nature these often have unique value – finding an “uncontrolled” price for Google’s search algorithm or a new drug formula is next to impossible, leading to complex valuation techniques.
- Compliance Burden (Documentation and Reporting):** The administrative load of transfer pricing compliance is heavy. Multinationals must produce voluminous documentation each year – a local file report can easily run into hundreds of pages with economic analyses. As regulations tighten (e.g., through BEPS Action 13), even **mid-sized companies now face Master File and CbC reporting** if they cross thresholds. For a lean startup, dedicating resources to prepare transfer pricing studies and maintain evidence can be onerous. Yet, failure to do so is risky – many jurisdictions impose penalties regardless of tax impact, simply for not having proper documentation in place.⁷ This makes **compliance a costly but necessary investment.** Startups often mitigate this by seeking professional help or using standardized benchmarking for common transactions.
- Risk of Adjustments and Penalties:** If tax authorities suspect that profits are shifted via pricing, they can and will make **transfer pricing adjustments** – increasing taxable income in their jurisdiction. Such adjustments can be large and

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<https://www.internationaltaxreview.com/article/2dt4hfi2hdyoaiycv5vy8/sponsored/penalties-in-transfer-pricing-controversy-always-show-your-working#:~:text=Penalties%20in%20transfer%20pricing%20controversy%3A>,

often come with interest and penalties. For instance, the IRS in the U.S. ramped up enforcement in recent years, asserting nearly \$2 billion in transfer pricing penalties in just a three-year span.⁸ India's tax authorities historically made aggressive adjustments in high-profile cases (some running into thousands of crores of rupees).

Penalties for non-compliance are substantial: apart from financial penalties (which can be percentage-based and quickly add up), there's also the risk of reputational damage. A startup found non-compliant may scare off investors or acquirers who see potential unknown tax liabilities.

- **Double Taxation and Disputes:** One company's adjustment is another's double tax. A classic challenge is that when Country A's tax authority increases Company A's income (saying a transfer price was too low), Country B might not correspondingly allow Company B (the counterparty) to reduce its income. This leads to **double taxation** of the same profit. Resolving such issues requires **dispute resolution mechanisms** like Mutual Agreement Procedure (MAP) under tax treaties, which can be time-consuming and uncertain, or proactive measures like APAs (Advance Pricing Agreements) to get prior concurrence of tax authorities on pricing. For businesses, especially smaller ones, engaging in lengthy disputes or MAP negotiations (which can take years) is resource-intensive and disruptive.
- **Evolving Regulations and Tax Environments:** Transfer pricing rules aren't static. Countries continuously update regulations, documentation formats, and safe harbor rules. The OECD is also working on new frameworks (like the recent discussions on global minimum tax and possibly re-thinking profit allocation for digital commerce beyond arm's length principle). Keeping abreast of these changes is a challenge – what was acceptable last year might trigger questions this year due to a rule change. For example, **China** has its own take emphasizing location-specific advantages; **India** introduced *secondary adjustments* (requiring excess profits adjusted to be actually repatriated or else treated as a deemed loan). Finance teams must stay informed or risk falling out of compliance.
- **Complex Transactions (intangibles, services, cost sharing):** Certain transaction types pose special difficulties:
 - **Intangible assets:** How to price a brand, a patented technology, or customer relationships? These often make or break a company's value, and valuation is

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https://kpmg.com/kpmg-us/content/dam/kpmg/taxnewsflash/pdf/2024/01/taxnewsflash-182tnf0311-Horowitz_Bettge_Gerling_Barron.pdf#:~:text=.almost%20%242%20billion%20in%20penalties

complex. Companies might charge royalties or transfer IP between entities, and tax bodies scrutinize whether those royalty rates reflect true value. Major disputes globally often center on intangibles (e.g., valuing the IP that tech companies migrate to tax-friendly jurisdictions).

- **Intra-group services:** Multinationals often have a parent or regional hub providing services like management oversight, IT support, or marketing to subsidiaries. Charging for these services (often called management fees or shared services charges) is tricky – the subsidiary may argue the benefit is unclear or not worth the fee, while tax authorities ask for proof that the charge is reasonable. The arm's length test is whether an independent party would pay for that service (the *benefit test*). Documenting benefits and allocation keys (say, allocating HQ costs based on revenue or headcount) can be contentious.
- **Intercompany financing:** Loans or guarantees between related parties bring challenges of determining arm's length interest rates or guarantee fees, factoring in credit ratings that might not exist but for the parent's backing.

In summary, the challenges in transfer pricing revolve around *justifying the numbers*. It requires careful analysis, thorough documentation, and often negotiation with tax officials. Non-compliance or simplistic approaches (like arbitrarily setting a price with no analysis) can easily backfire. A stark reminder of the stakes: **Coca-Cola was hit with an adjustment of roughly \$3.3 billion in U.S. taxes after a transfer pricing court dispute**, and other giants like Amazon, Apple, Starbucks have all faced high-profile transfer pricing controversies. For a smaller company, the scales are different but the principles are the same – getting it wrong can mean a significant hit to the bottom line and operational headaches.

Best Practices for Transfer Pricing Compliance

Here are some **best practices** for ensuring compliance and minimizing issues:

1. **Develop a Clear Transfer Pricing Policy:** Establish a well-defined transfer pricing policy aligned with your business strategy. This policy should detail how intercompany prices are set, the rationale behind pricing decisions, and procedures for regular review.
2. **Use the Arm's Length Principle:** Ensure all transfer prices reflect what independent parties would agree upon in similar circumstances, adhering strictly to the arm's length principle.
3. **Clearly Define Roles and Responsibilities (FAR Analysis):** Conduct a thorough analysis of Functions, Assets, and Risks (FAR) for each related entity. Precisely document the roles, assets employed, and risks assumed to support your pricing and profit allocations.
4. **Maintain Robust Documentation (Local File):** Prepare comprehensive, contemporaneous transfer pricing documentation detailing your intercompany transactions, functional analyses, benchmarking studies, and financial calculations. This documentation is vital for compliance and audit readiness.
5. **Consider Advance Pricing Agreements (APAs):** For complex or high-value transactions, explore Advance Pricing Agreements with tax authorities to obtain prior certainty on pricing methods and reduce the risk of disputes.
6. **Use Safe Harbors if Available:** Leverage safe harbor provisions, such as those offered under Indian transfer pricing regulations, to simplify compliance when your transactions meet specified criteria.
7. **Ensure Intercompany Agreements are in Place:** Formalize all significant related-party transactions through written agreements outlining terms, pricing, and responsibilities to substantiate the commercial substance of transactions.

Transfer Pricing Case Study: Coca-Cola vs. IRS

The primary objective of transfer pricing regulations is to ensure that multinational enterprises (MNEs) conduct their intercompany transactions at arm's length, meaning that the prices charged are consistent with those that would be agreed upon between independent parties in comparable circumstances.⁹ This principle is fundamental to preventing tax base erosion and profit shifting, where companies might artificially inflate or deflate prices in cross-border transactions to shift profits to lower-tax jurisdictions, thereby reducing their overall tax liability.

This case serves as a compelling illustration of the complexities inherent in transfer pricing, particularly concerning the valuation of intangible assets, and highlights the potential for substantial financial consequences arising from transfer pricing adjustments.¹⁰ The Coca-Cola case is widely recognized as a major transfer pricing dispute, making it a relevant and impactful example for understanding the intricacies of this field.

A. Background

The transfer pricing dispute in question involved The Coca-Cola Company (TCCC), a U.S.-based multinational beverage corporation, and the Internal Revenue Service (IRS), the tax authority of the United States. The core of the disagreement centered on the appropriate pricing of intellectual property used by Coca-Cola's foreign subsidiaries during the tax years 2007 through 2009. Coca-Cola operates globally, with its foreign subsidiaries playing a crucial role in manufacturing, distributing, and selling the company's beverage products in various markets. This extensive global network and the highly valuable intangible property associated with the Coca-Cola brand make the company a significant subject for transfer pricing scrutiny.

B. Core Issue: Royalty Payments for Intellectual Property

The primary point of contention between Coca-Cola and the IRS revolved around the royalty payments made by Coca-Cola's foreign subsidiaries to the U.S. parent company for the use of its valuable intellectual property. This IP included trademarks, formulas, brand names, patents, secret formulas, and proprietary manufacturing processes. The IRS argued that Coca-Cola was undercharging its foreign subsidiaries for the use of this IP, leading to an underpayment of U.S. taxes.

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<https://www.gov.uk/government/publications/transfer-pricing-and-diverted-profits-tax-statistics-2023-to-2024/transfer-pricing-and-diverted-profits-tax-statistics-2023-to-2024>

¹⁰ <https://www.journalofaccountancy.com/issues/2025/mar/transfer-pricing-not-just-for-the-tax-department/>

C. Arguments Presented by the IRS

1. Coca-Cola had been using a profit split formula known as the "10-50-50 method," which was agreed upon in a 1996 settlement with the IRS. Under this method, Coca-Cola's foreign supply points retained 10% of their gross sales as profit, while the remaining profit was split equally between the U.S. parent company and its foreign supply points. However, for the tax years 2007-2009, the IRS deemed this method no longer appropriate.
2. In 2007, the IRS changed its strategy and adopted the Comparable Profits Method (CPM), using data from Coca-Cola's independent bottlers as benchmarks. Applying the CPM, the IRS argued that Coca-Cola's foreign subsidiaries were earning excessive profits compared to independent bottlers, leading to the conclusion that the U.S. parent company was undercompensated for the use of its intellectual property. This shift by the IRS to the CPM indicates a more stringent approach to valuing intangible property and a preference for market-based comparisons.
3. The IRS's decision to move away from a previously agreed-upon method to a different methodology suggests a change in their assessment of the arm's length price for the use of Coca-Cola's IP. This highlights the nature of transfer pricing regulations and the potential for tax authorities to revise their approaches based on evolving economic conditions and their interpretation of the arm's length principle.

D. Arguments Presented by Coca-Cola

1. In its defense, Coca-Cola argued that the longstanding acceptance of the 10-50-50 method for over a decade should be taken into consideration. The company contended that the 1996 settlement with the IRS should provide certainty over its transfer pricing practices. Furthermore, Coca-Cola asserted that its foreign subsidiaries owned valuable marketing intangibles that were not accounted for in the IRS's CPM analysis.
2. The company argued that these marketing intangibles, developed and owned by the foreign subsidiaries, justified the higher profits they earned. By emphasizing the prior agreement with the IRS and the value created by its foreign subsidiaries through local marketing efforts, Coca-Cola aimed to demonstrate that its profit allocation was consistent with the arm's length principle, considering the specific facts and circumstances of its global operations.

E. Jurisdiction and Court Decision

1. In 2020, the United States Tax Court confirmed the IRS's position, upholding the transfer pricing adjustments proposed by the tax authority. The court agreed with the IRS that Coca-Cola's transfer pricing method did not result in an arm's length allocation of profits. Specifically, the Tax Court found that the IRS's use of the CPM was appropriate and that Coca-Cola's foreign subsidiaries were indeed earning excessive profits compared to independent bottlers.
2. The court rejected Coca-Cola's arguments that the 1996 settlement should provide certainty over its transfer pricing and that the IRS's adjustments were barred by Brazilian law. As a result of the Tax Court's decision, Coca-Cola was found to owe additional taxes of approximately \$2.7 billion and applicable interest of approximately \$3.3 billion for the tax years 2007-2009.
3. This decision underscores the authority of tax authorities to scrutinize and adjust transfer pricing methods, even those previously agreed upon, to ensure compliance with the arm's length principle. The court's ruling against Coca-Cola, despite the existence of a prior settlement, demonstrates that tax authorities can challenge transfer pricing arrangements if they believe they no longer reflect an arm's length outcome. This highlights the importance of regularly reviewing and updating transfer pricing policies to align with current regulations and economic realities.

F. Impact and Implications

This case reinforces the importance of adhering to the arm's length principle as the fundamental standard for transfer pricing. It also serves as a critical reminder for multinational companies to carefully evaluate and thoroughly document the valuation of their intangible property used by foreign subsidiaries. The Coca-Cola case demonstrates the IRS's willingness to challenge established transfer pricing methods and even prior agreements if they are deemed not to reflect an arm's length result. This highlights the critical role of comprehensive and well-reasoned transfer pricing documentation to support the chosen methods and withstand scrutiny from tax authorities.

G. Key Takeaway

The core issue centered on the valuation of Coca-Cola's valuable intangible property and whether the royalty payments made by its foreign subsidiaries to the U.S. parent company reflected an arm's length price. The Tax Court's decision to uphold the IRS's adjustments,

rejecting Coca-Cola's reliance on a prior settlement and favoring the Comparable Profits Method, resulted in a substantial tax liability for the company.

This case underscores the inherent challenges in applying transfer pricing regulations, particularly when dealing with intangible assets. It highlights the potential for significant disagreements between multinational enterprises and tax authorities regarding the appropriate valuation and pricing of intercompany transactions.

Conclusion

Transfer pricing is not just a regulatory requirement but a strategic element of global business management. As companies expand internationally, setting appropriate intercompany prices becomes crucial to maintaining compliance and managing tax liabilities. This guide has covered the fundamental principles of transfer pricing, from the **Arm's Length Principle (ALP)** to the diverse methods used to determine fair pricing, such as the **Comparable Uncontrolled Price (CUP) Method**, **Resale Price Method (RPM)**, **Cost Plus Method (CPM)**, **Transactional Net Margin Method (TNMM)**, and **Profit Split Method (PSM)**.

We have also explored the global regulatory landscape, focusing on the OECD guidelines and India-specific regulations, including critical documentation practices such as maintaining the **Local File**, **Master File**, and **Country-by-Country (CbC) reporting**. Real-world examples, like the Coca-Cola case, highlight the financial and operational risks of non-compliance, emphasizing the importance of meticulous transfer pricing practices.

For startups and SMEs, addressing transfer pricing challenges proactively is essential for sustaining international growth while minimizing tax risks. By developing clear policies, maintaining robust documentation, and regularly reviewing pricing arrangements, businesses can align their practices with global standards and mitigate compliance challenges.

For any assistance or specific queries related to transfer pricing, feel free to reach out to us at priya@treelife.in.

Get in touch with us

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