

DESAI SAKSENA & ASSOCIATES

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Friday Tax Alert

From:

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ITAT upholds use of Royalty savings method over TPO's CUP method approach for determining ALP of Intangibles.

This case from the Ahmedabad Income Tax Appellate Tribunal (ITAT) concerns Transfer Pricing (TP) adjustments for Assessment Year (AY) 2007-08, particularly regarding purchase/valuation of intangible assets and sale of finished goods to its Associated Enterprise (AE).

Background of the Case:

- Heubach Colour Pvt. Ltd. acquired the business of 'Avecia' from its Associated Enterprise (AE).
- This included valuable intangible assets: trademarks, technical know-how and goodwill.
- Heubach relied on a valuation report by an independent Chartered Accountant (CA), which used an income-based approach to value these intangibles, focusing on the future economic benefits they would generate.

Dispute: Transfer Pricing Officer (TPO)'s Stand:

- The TPO disagreed with the CA's valuation method.
- He instead used the Comparable Uncontrolled Price (CUP) method.
- The TPO argued that the price paid by the AE to Avecia in 2002 for similar assets should be used as the Arm's Length Price (ALP) in the current transaction.

CIT(A)'s and ITAT's Findings:

The Commissioner of Income Tax (Appeals) [CIT(A)] and later the ITAT disagreed with the TPO on several grounds:

- **CUP Method Not Suitable**
 - The CUP method can't be used unless differences in the transactions are accounted for (e.g., time gap, business environment changes).
 - Prices from 2002 can't be reliably applied to a transaction in AY 2007-08 due to inflation, market changes and other factors.
- **Valuation Approach Accepted**
 - The Net Present Value (NPV) based income approach was considered acceptable.
 - **The Royalty Savings Method, used by the CA, was a recognised OECD methodology for valuing intangibles.**
- **Adjustment to Royalty Rates**
 - The CA had used high royalty rates (10 for technical know-how, 5 for trademarks).
 - CIT(A) revised these based on OECD Transfer Pricing Guidelines to:
 - 3.5 for technical know-how, and
 - 3 for trademarks - more reasonable and justifiable

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Double Addition Dispute:

- TPO had reduced the value of intangible assets by INR 54.03 crore (INR 54,03,30,087), which reduced the depreciation claim. Also proposed an upward income adjustment of the same amount, assuming the Assessee transferred cash to AE.
- CIT(A) held that this was a double addition where the same value being adjusted twice.
- The AO/TPO didn't cite any specific provisions of the Income Tax Act for this addition.
- ITAT agreed that even if cash was transferred, it couldn't justify adding that amount as income.

TP Adjustment on Sale of Finished Goods

- Heubach sold finished goods (including Avecia products) to its AE.
- Assessee used the Transactional Net Margin Method (TNMM) for benchmarking; TPO rejected it.
- TPO applied a 15 royalty mark-up on sales to AE.
- CIT(A):
 - Upheld TPO's rejection of TNMM but modified the approach.
 - Applied 6.5 royalty rate instead, based on FAR (Functions, Assets, Risks) analysis.
 - Limited the adjustment only to sales of Avecia products, since the high mark-up related only to these (75.86 of the sales).

ITAT's Final Ruling:

- Found no error in CIT(A)'s reasoning.
- Dismissed revenue's appeal and sided with the assessee on all key issues.

Key Takeaways:

- The CUP method can't be applied without adjustments for transactional differences.
- Income based valuation methods like royalty savings are acceptable for intangible assets.
- Double adjustments for the same transaction are not permissible.
- Adjustments must be specifically tied to relevant transactions (e.g., only Avecia product sales).
- Reliance on OECD TP Guidelines is appropriate for determining reasonable royalty rates.

Heubach Colour Pvt. Ltd [TS-185-ITAT-2025-TP]

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Amendment in Safe Harbour Rules (SHR) (Rule 10TA, 10TD and 10TE)

Safe Harbour Rules (SHR) lay down the circumstances in which the tax authorities shall accept the transfer price declared by the taxpayer. On 25th March 2025, the CBDT has issued Notification No. 21/2025 amending the SHR as follows:

1. Amendment in the definition of "core auto components" under Rule 10TA(b)

As per the earlier definition, "core auto components" would mean:

- i. engine and engine parts, including piston and piston rings, engine valves and parts cooling systems and parts and power train components;
- ii. transmission and steering parts, including gears, wheels, steering systems, axles and clutches;
- iii. suspension and braking parts, including brake and brake assemblies, brake linings, shock absorbers and leaf springs.

The above definition has been amended to include –

- iv. *lithium ion batteries for use in electric or hybrid electric vehicles.*

2. Increase in the limit for availing safe harbour from ₹ 200 Crores to ₹ 300 Crores (Rule 10TD(2A)):

(Rule 10TD(1)): Where an eligible Assessee has entered into an eligible international transaction and the option exercised by the said Assessee is not held to be invalid under Rule 10TE, the transfer price declared by the Assessee in respect of such transaction shall be accepted by the income-tax authorities, if it is in accordance with the circumstances as specified in sub-rule (2) or, as the case may be, sub-rule (2A)

Rule 10TD(2A): The circumstances referred to in sub-rule (1) in respect of the eligible international transaction specified:

Eligible International Transaction	Circumstances
Provision of software development services	The operating profit margin declared by the eligible Assessee from the eligible international transaction in relation to operating expense incurred is – <ul style="list-style-type: none">• not less than 17%, where the value of international transaction does not exceed ₹ 100 crore; or• not less than 18%, where the value of international transaction exceeds ₹ 100 crore but does not exceed ₹ 300 crore.
Provision of information technology enabled services	The operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense is—

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	<ul style="list-style-type: none"> not less than 17%, where the aggregate value of such transactions entered into during the previous year does not exceed ₹ 100 crore; or not less than 18%, where the aggregate value of such transactions entered into during the previous year exceeds ₹ 100 crore but does not exceed ₹ 300 crore.
Provision of knowledge process outsourcing services	<p>The value of international transaction does not exceed ₹ 300 crore and the operating profit margin declared by the eligible assessee from the eligible international transaction in relation to operating expense is –</p> <ul style="list-style-type: none"> not less than 24% and the Employee Cost in relation to the Operating Expense is at least 60%; not less than 21% and the Employee Cost in relation to the Operating Expense is 40% or more but less than 60%; or not less than 18% and the Employee Cost in relation to the Operating Expense does not exceed 40%.
Provision of contract research and development services wholly or partly relating to software development	<p>The operating profit margin declared by the eligible Assessee from the eligible international transaction in relation to operating expense incurred is not less than 24%, where the value of the international transaction does not exceed ₹ 300 crore.</p>
Provision of contract research and development services wholly or partly relating to generic pharmaceutical drugs	<p>The operating profit margin declared by the eligible Assessee from the eligible international transaction in relation to operating expense incurred is not less than 24%, where the value of the international transaction does not exceed ₹ 300 crore.</p>

3. **Amendment in Rule 10TD(3B):**

The applicability of SHR has been extended to assessment years **2025-26 and 2026-27**.