Indian Tax Administration issues final rules on transfer pricing safe harbor

Executive summary

The Finance (No 2) Act (FA), 2009 introduced provisions in the Indian Income-tax Law (ITL) that empowered the Central Board of Direct Taxes (CBDT), the apex Indian Tax Administration, to issue transfer pricing “safe harbor” rules. A “safe harbor” is defined in the ITL as circumstances in which the Tax Authority shall accept the transfer price declared by the taxpayer. The CBDT on 14 August 2013 released draft safe harbor rules for public comments. After considering comments of various stakeholders, on 18 September 2013, the CBDT issued the final safe harbor rules.

The rules provide minimum operating profit margins in relation to operating expenses a taxpayer is expected to earn for certain categories of international transactions, such as provision of software development services, information technology enabled services, (ITES), knowledge process outsourcing (KPO) services, contract research and development (R&D) services, manufacture and export of automotive components etc. that will be acceptable to the Tax Authority. The rules also provide acceptable norms for certain categories of financial transactions such as intra-group loans made or guarantees provided to nonresident affiliates of an Indian taxpayer.

The transfer price contained in the safe harbor rules shall be applicable for five years beginning from financial year (FY) 2012-13. The safe harbor rules, optional for a taxpayer, contain the conditions and circumstances under which the norms/margins would be accepted by the Tax Authority and the related compliance obligations. The taxpayer has flexibility in electing the years to be governed by the safe harbor rules within the five year period. Where a taxpayer’s transfer price is accepted by the Tax Authority under the safe harbor rules, the taxpayer shall not be entitled to invoke the mutual agreement procedure (MAP) under an applicable tax treaty.
Background

The FA 2009 introduced provisions in the ITL that empowered the CBDT, to issue transfer pricing “safe harbor” rules. A “safe harbor” is defined in the ITL as circumstances in which the Tax Authority shall accept the transfer price declared by the taxpayer. On 14 August 2013, the CBDT released draft safe harbor rules for public comments. After considering comments of various stake holders, on 18 September 2013, the CBDT issued the final rules. The notification introduces new Rules 10TA to 10TG that contain the procedure for adopting safe harbors, the transfer price to be adopted, the compliance procedures upon adoption of safe harbors and circumstances in which a safe harbor adopted may be held to be invalid.

International transactions and applicable safe harbor transfer price

The transfer price declared by an eligible taxpayer shall be accepted by the Tax Authorities for the below mentioned international transactions (eligible international transactions) subject to the ceilings/circumstances stated as under:

<table>
<thead>
<tr>
<th>Eligible international transaction</th>
<th>As per the draft rules</th>
<th>As per the final rules</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Threshold limit prescribed</td>
<td>Safe harbor margin</td>
</tr>
<tr>
<td>Provision of software development services other than contract R&amp;D with insignificant risks</td>
<td>Up to INR 1 billion</td>
<td>20 % or more on total operating costs</td>
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<tr>
<td>Provision of information technology enabled services other than contract R&amp;D with insignificant risks</td>
<td>Up to INR 1 billion</td>
<td>20 % or more on total operating costs</td>
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<td></td>
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<tr>
<td>Provision of information technology enabled services being knowledge processes outsourcing services other than contract R&amp;D with insignificant risks</td>
<td>Up to INR 1 billion</td>
<td>30 % or more on total operating costs</td>
</tr>
<tr>
<td>Advancing of intra-group loan to a nonresident wholly owned subsidiary</td>
<td>Up to INR 500 million</td>
<td>The Interest rate declared in relation to the international transaction, is equal to or greater than the base rate of State Bank of India (SBI) as of 30 June of the relevant previous year plus 150 basis points</td>
</tr>
<tr>
<td>Eligible international transaction</td>
<td>As per the draft rules</td>
<td>Safe harbor margin</td>
</tr>
<tr>
<td>---------------------------------------------------------------------------------------------------</td>
<td>------------------------</td>
<td>--------------------</td>
</tr>
<tr>
<td><strong>Threshold limit prescribed</strong></td>
<td><strong>Safe harbor margin</strong></td>
<td></td>
</tr>
<tr>
<td>Advancing of intra-group loan to a nonresident wholly owned subsidiary</td>
<td>Above INR 500 million</td>
<td>The Interest rate declared in relation to the international transaction is equal to or greater than the base rate of SBI as of 30 June of the relevant previous year plus 300 basis points</td>
</tr>
<tr>
<td>Providing explicit corporate guarantee to wholly owned subsidiary (WOS)</td>
<td>Up to INR 1 billion</td>
<td>The commission or fee declared in relation to the international transaction is at the rate of 2% or more per annum on the amount guaranteed</td>
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<td></td>
<td></td>
<td>Above INR 1 billion, provided the WOS has been rated to be of adequate to highest safety by a rating agency registered with SEBI</td>
</tr>
<tr>
<td>Provision of specified contract R&amp;D services wholly or partly relating to software development with insignificant risks</td>
<td>No limit</td>
<td>30% or more on total operating costs</td>
</tr>
<tr>
<td>Provision of contract R&amp;D services wholly or partly relating to generic pharmaceutical drugs with insignificant risks</td>
<td>No limit</td>
<td>29% or more on total operating costs</td>
</tr>
<tr>
<td>Manufacture and export of core auto components</td>
<td>No limit</td>
<td>12% or more on total operating costs</td>
</tr>
<tr>
<td>Manufacture and export of noncore auto components where 90% or more of total turnover during the relevant previous year is in the nature of original equipment manufacturer (OEM) sales</td>
<td>No limit</td>
<td>8.5% or more on total operating costs</td>
</tr>
</tbody>
</table>
In order to identify an eligible taxpayer with insignificant risk, the factors outlined in the rules are similar to the conditions stated under Circular 6 of 2013 for identifying contract R&D centers bearing insignificant risks. These conditions broadly require the foreign principal or its Associated Enterprises (AEs) to perform economically significant functions and provide capital and other economically significant assets. The Indian entity is expected to work under the supervision of the foreign principal or its AEs who have capability to control or supervise the work of the Indian entity. The Indian entity should not assume any economically significant risk. The terms software development services; ITES; knowledge processes outsourcing services; intra-group loan; corporate guarantee; contract R&D services wholly or partly relating to software development, generic pharmaceutical drugs; core auto components, non-core auto components, operating expense, operating revenue, operating profit margin in relation to operating expense have been defined in the Rules.

Filing of Form 3CEFA

Any taxpayer who has entered into an eligible international transaction and who wishes to exercise the option to be governed by the safe harbor rules is required to file a specified form (Form 3CEFA) and furnish it before the due date for filing the tax return for:

- The relevant financial year (April-March), in case the option is exercised only for that financial year or;
- The first of the financial years, in case the option is exercised for more than one financial year.

The form is in the nature of a self-declaration and needs to be signed by the person who is authorized to sign the tax return. The option for safe harbor validly exercised shall continue to remain in force for the period specified in Form 3CEFA or a period of five years, whichever is less. Form 3CEFA requires the taxpayer to declare the following:

- Transaction entered with an AE is an eligible international transaction;
- Quantum of the international transaction;
- Whether the AEs country or territory is a no tax or low tax country or territory; and
- Operating profit margin/transfer price.

Validity of safe harbor option

The safe harbor option shall remain in force with respect to any financial year unless:

- The option is held to be invalid for the financial year by the transfer pricing officer (TPO) with respect to an objection filed by the taxpayer against the order of the TPO; or
- The taxpayer opts out of the safe harbor for the relevant tax year by filing a declaration to this effect with the assessing officer (AO).

Assessment procedure

The Rules empower the AO/TPO to verify whether the taxpayer exercising the safe harbor option is an eligible taxpayer and whether the transaction for which the option is exercised is an eligible international transaction or not. The AO/TPO is also empowered to call for any information/documents/explanation for verifying any of the above. Where the AO/TPO is of the opinion that the option exercised by the taxpayer is valid, he shall intimate acceptance of the transfer price declared by the taxpayer within the specified timelines and after following the specified procedure. However, if the AO/TPO is not satisfied that the option exercised by the taxpayer is valid, then he shall proceed to determine the transfer price in accordance with the other ITL provisions and without having regard to the safe harbor price/margin. Such order of the TPO can be appealed before the Commissioner (to whom the TPO is subordinate).

The Rules also provide that where the transfer price declared by the eligible taxpayer is accepted by the income tax authorities, such taxpayer shall not be eligible to invoke the MAP under the relevant tax treaty.
Further, the rules also provide timelines within which the tax authorities need to take action on the option exercised by the taxpayer. These are:

<table>
<thead>
<tr>
<th>Action</th>
<th>Timeline</th>
</tr>
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<tbody>
<tr>
<td>Reference by AO to TPO to determine eligibility of assessee or international transaction or both for purposes of the safe harbor</td>
<td>Two months from the end of the month in which Form 3CEFA is received by AO</td>
</tr>
<tr>
<td>TPO to pass an order after determining validity or otherwise of the option exercised by the assessee</td>
<td>Two months from the end of the month in which reference from AO is received</td>
</tr>
<tr>
<td>Commissioner to pass an order with respect to the validity or otherwise of the option exercised by the assessee</td>
<td>Two months from the end of the month in which the objections filed by the assessee are received</td>
</tr>
</tbody>
</table>

If the AO / TPO or the Commissioner does not make a reference or pass an order, as the case may be, within the time specified above, then the option of the safe harbor exercised by the assessee shall be treated as valid.

Ineligible taxpayers

The safe harbor provisions shall not be applicable to a taxpayer who has entered into an eligible international transaction with an AE located in a country or territory notified under Section 94A of the ITL, or in a no-tax or low-tax country/territory. No-tax or low-tax country/territory has been defined as a country or territory in which the maximum rate of income tax is less than 15% for the AE. However, to date no country or territory has been notified for the purposes of Section 94A of the ITL.

Other key aspects

- The transfer price contained in the safe harbor rules shall be applicable for five years beginning from financial year 2012-13.
- Taxpayers can elect to be governed by the safe harbor rules for all or any of the five year period.
- Taxpayers electing the safe harbor will not be able to claim any further adjustment to the price, either on account of comparability differences or the benefit of the range as prescribed under the second proviso to Section 92C(2) of the ITL.
- Taxpayers opting for the safe harbor shall be required to maintain the mandatory prescribed transfer pricing documentation and also file the Accountant’s report in Form 3CEB.

Implications

Applying the arm’s length principle can be a resource-intensive process. It may impose a heavy administrative burden on taxpayers and tax administrations that can be exacerbated by both complex rules and resulting compliance demands. These facts may lead to consideration of whether and when safe harbor rules would be appropriate in the transfer pricing area. Some of the difficulties that arise in applying the arm’s length principle may be avoided by providing circumstances in which eligible taxpayers may elect to follow a simpler set of prescribed transfer pricing rules in connection with clearly and carefully defined transactions.

In the Indian context, a number of taxpayers find themselves in the challenging position of documenting and defending their transfer pricing issues. Transfer pricing controversy is on the rise due to increasingly well-staffed tax authorities applying more sophisticated and sweeping transfer pricing tools. Hence, specifically targeted safe harbor rules can provide certainty that the taxpayer’s transfer prices will be accepted, provided they have met the eligibility conditions of, and complied with, the safe harbor provisions.

Some of the concerns raised by stakeholders on the draft rules have been addressed in the final rules. The rules now are applicable for a period of five years compared to two years proposed in the draft. Further, the eligibility threshold of turnover of less than INR 1 billion for software development and ITES transactions have been done away with, potentially allowing a larger number of taxpayers to qualify.
However, some of the provisions contained in the rules do seem to raise questions on whether the norms correspond in all cases to an outcome that may arise if a taxpayer properly applied the arm’s length principle using the most appropriate method applicable to the facts and circumstances under the general transfer pricing provisions. One major concern in such cases is that it may increase the risk of double taxation if the country where the AE is resident does not accept the safe harbor norms as arm’s length. The fact that the rules also preclude exercising the MAP option increases the risk of double taxation. The Organisation of Economic Cooperation and Development (OECD) recently approved a revision to its guidance on safe harbors (Chapter IV of the OECD Transfer Pricing Guidelines). The OECD encourages the use of safe harbors on a bilateral or multilateral basis as they provide significant benefits without raising the risk of double taxation or double non-taxation.

Properly designed safe harbors may also significantly ease compliance burdens by eliminating data collection and associated documentation requirements in exchange for the taxpayer pricing qualifying transactions within the parameters set by the safe harbor. However, the Indian rules still seem to require taxpayers who elect the safe harbors to maintain prescribed documentation.

Taxpayers should evaluate the impact of these rules on their inter-company pricing arrangements and consider options for transfer pricing risk management.

Endnotes
For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP (India), Bangalore**
- Rajendra Nayak  +91 80 4027 5454  rajendra.nayak@in.ey.com

**Ernst & Young LLP (India), New Delhi**
- Vijay Iyer  +91 114 363 3240  vijay.iyer@in.ey.com

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**EY Transfer Pricing**

- **Global Transfer Pricing**, Germany
  Thomas Borstell, +49 211 9352 10601

- **Americas**, United States
  Purvez Captain, +1 713 750 8341

- **EMEIA**, Germany
  Oliver Wehnert, +49 211 9352 10627

- **Asia Pacific**, Singapore
  Luis Coronado, +65 6309 8826

- **Japan**, Tokyo
  Kai Hielscher, +81 3 3506 1356

- **Global Markets**, United Kingdom
  John Hobster, +44 207 951 6438

- **TESCM**, Amsterdam
  Victor Bartels, +31 88 4071378
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