Tax Experts' react to final Safe Harbour rules

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Dinesh Kanabar, Deputy CEO, KPMG India :

This is a very positive development. This should help overcome massive potential TP litigation and create a right tax environment. I wish the clarification that safe harbour does not create a presumption was also made.

Samir Gandhi, Partner, Deloitte Haskins & Sells

Removal of threshold for ITS and ITES activities of Rs. 100 crore per press release is a positive step. While one needs to study the fine print of the notified Rules, with no upper threshold limit on the amount of such international transactions, it seems large companies e.g. big outsourcing units of US and European MNCs can opt for safe harbour norms albeit with a higher mark up of 22% for transactions above Rs. 500 crore. And the mark up of 20% upto the increased threshold limit of Rs. 500 crore is also positive. However, the probability of a taxpayer opting for safe harbour norms will be the factor of cost of litigation including MAP/APA V. the extra markup (premium paid) for certainty for safe harbour. It is to be noted that safe harbour mark ups are normally kept higher than the arm's length mark up.

While the reduction in mark up to 25% in case of KPO activities is welcome, it would have been helpful if separate category of KPO segment would have been merged with ITS/ITES segment referred to above. Practically, it's not easy to determine and distinguish between ITS/ITES and KPO, especially when such determination will require the domain and technical knowledge of the relevant activities involved. units of US and European MNCs can opt for safe harbour norms albeit with a higher mark up of 22% for transactions above Rs. 500 crore. And the mark up of 20% upto the increased threshold limit of Rs. 500 crore is also positive. However, the probability of a taxpayer opting for safe harbour norms will be the factor of cost of litigation including MAP/APA V. the extra markup (premium paid) for certainty for safe harbour. It is to be noted that safe harbour mark ups are normally kept higher than the arm's length mark up.

The other important point still to be tested is the eligibility conditions on determination of ‘insignificant risk’. This will be a factual exercise & intensive exercise and can lead to almost like an audit to test whether the taxpayer bears insignificant risk as laid down in the draft rules.

Administrative simplification of application of the rules for 5 years is another positive development so also the reduction in timeline of 2 months to grant / reject the option availed by the taxpayer.

Whilst there is no doubt that the release of the long-awaited safe harbour rules is in the right direction and very welcome step, it is hoped that the Revenue authorities either at the field level or during the course of APA/MAP negotiations will not consider the safe harbour margins to be the deemed arm’s length price. To this end, it would be good if the Rules could specifically incorporate the recommendation of the Rangachary Committee which mentions that a directive should be given to the Assessing /Officer / TPO that safe harbours should not become a rebuttable presumption for a taxpayer who opts not to go for it and has an arm’s length price below the safe harbour.

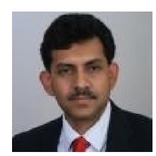
Mr. Subhankar Sinha, VP, Head of Taxation, Siemens South Asia

“The final safe harbor rules show a clear improvement over the draft rules in terms of coverage and rationalization of definitions & target profit margins.

However, given the current pressures on profitability and stiff competition from other jurisdictions, it would be difficult for many MNCs to opt for this regime.

Also, it would have been better if the Rules allowed dispensation from maintenance of documentation.”

Mr. Rahul K Mitra, Partner , Price Waterhouse & Co.



1. As has been discussed, earlier, safe harbour rates are not arm's length prices (ALPs) but in the nature of presumptive taxation, which generally enthuse taxpayers to opt for the same as a compromise for not having to be involved in protracted litigation in a bid to obtain better results in taxation under substantive revenue audits.

2. Thus, the rates specified in the final safe harbour rules for captive service providers, namely (a) 20 & 22% for IT & ITeS, depending upon the turnover threshold of INR 5 billion or above, respectively (as against 20%, with a turnover threshold of INR 1 billion, as proposed in the draft safe harbour rules); (b) 25% for KPOs, without any turnover threshold (as against 30%, with a turnover threshold of INR 1 billion, as proposed in the draft safe harbour rules); (c) 29 & 30% for contract R&D for pharma & IT respectively, without any turnover threshold (no changes have been made to the original proposals in the draft safe harbour rules), etc, are not ALPs, but in the nature of offers made by the Indian Revenue as compromises to avoid litigation.

3. Whether or not any taxpayer should consider adopting the safe harbour rates, would actually depend upon its scale of operations, vis-a-vis the resultant tax impact. For instance, a captive player in the IT or ITeS sector, having a cost base of say INR 1 billion, might consider going for a safe harbour rate of 20%, since the incremental annual tax cost

@ 34%, which he might bear in India, in exchange of having peace & serenity, in a scenario where he could have got resolution from the Tribunal or APA at say 13 to 15%, may not be quite large, being INR 17 to 25 million or US$ 280,000 to 400,000 appx.

4. Thus, even if the Revenue of the country of the head quarter of the Indian taxpayer does not agree to the adoption of the safe harbour rate, which is a unilateral act of the taxpayer vis-a-vis the offer made by the Indian Revenue, the loss of tax in a year might not be significant, thus enticing such smaller captive service providers to opt for safe harbour rates.

5. However, for the larger players, having cost base of INR 2 or 5 billion or even higher, the situation changes, as the incremental tax cost increases proportionately by two or five times or even more. It is therefore unlikely that large captive payers would opt for such safe harbour rules, even in the IT & ITeS sectors.

6. For KPO and contract R&D sectors, the safe harbour rates are much higher, i.e. 25% & 30% respectively, with the automatic resultant impact on the "compromise tax", which a taxpayer might have to pay for opting for safe harbour rules, irrespective of its size or scale of operations, since it is unlikely that Revenues of the countries of the head quarters of such companies would agree to such high margins being awarded to their Indian captive service providers.

7. Thus, larger captive players in the field of IT & ITeS; and also captive players in general in the fields of KPO and contract R&D, might still not find the revised safe harbour rates lucrative enough to opt for the same, in view of economic double taxation, since the safe harbour rules in India are unilateral & not bilateral.

8. Such players would have to pursue normal TP documentation & audits, with the chances of facing protracted litigation, where the TPOs might use the safe harbour rates as "floors" & not "caps" for concluding the TP audits. Reliefs can be expected only at the level of the Tribunals.

9. This is where such large taxpayers should seriously consider the option for APAs for obtaining up-front resolution, given the pragmatism & positive attitude, which the APA team has already shown in their dealings with applicants ever since the APA programme got live last year.

10. While taxpayers might opt for either unilateral or bilateral APAs for proper resolution of their TP models, a bilateral APA would be preferable, since the bilateral APA team would operate under lesser fetters as compared to the unilateral APA team; and taxpayers would have the opportunity to plead resolution for mark-ups at a convenient convergence point of inter-quartile ranges (as per practice followed by other countries) & arithmetic mean (as per provisions enshrined in the Indian TP regulations), as opposed to the restricted usage of the arithmetic mean in a unilateral APA.

11. With the bilateral negotiations with US, being the source country with the maximum outsourcing work to India, opening up, post the recent deliberations between the Competent Authorities of US & India, the safe harbour rules might actually pave the way to a wave of bilateral APA filings by US MNCs, having captive operations in India in the

field of IT, ITeS, KPO, R&D, etc, for better up-front resolution of TP in India.

Mr. Vijay Iyer, Head of Transfer Pricing, Ernst & Young

Certainly a positive move. While some more modifications were sought by taxpayers, at least some significant steps have been taken. Coverage of larger companies and reduction of the safe harbour margins is a welcome step. Increase in duration of the safe harbours is very welcome. Some more rationalization of margins and artificial classification of IT and IT enabled service providers needs to be removed

Mr. Sudhir Nayak, Partner, SKP

It is a good move to provide certainty on the provision for a period of 5 years.For the IT and ITES sector the increase in threshold from Rs 100 crores to 500 crores to be eligible to be covered under safe harbour is a good decision and benefit could flow to higher number of companies. However the increase in rates from 20% to 22 % for companies with turnover over 500 crores should be by considering the turnover criteria in the year in which the safe harbour rules have been applied for the first time so that they are saved from the incremental 2% mark up in the year in which the turnover increases beyond 500 by say more than 10%.

The limit for KPO being reduced to 25% is a good move on the part of the government.

Rohan Phatarphekar, Partner & National Head - Global TP Services, KPMG

"In continuance with steps taken in recent times focusing on addressing tax payers issues, the Government has reviewed and finalized the safe harbour norms. More importantly, the Government's approach to positively consider the feedback received from various stake holders augurs well for the tax payers and will reduce Transfer Pricing litigation."

TP Ostwal, TP Ostwal & Associates

"I think this is positive thinking on part of CBDT to have revised the margins. However increasing turnover from Rs.100cr to 500cr doesnt make sense. It could have been across the board to all taxpayers. Instead of proposing guarantee margin of 1.75%, it should have been appropriately scaled down based on slabs, which is also how commercial banks negotiate guarantee rates with customer. In other words, higher the guarantee value lower should be the guarantee commission.

The Board also ought to have applied these rules retrospectively which would have brought down the litigation thrust on assessees. In an economic downturn, these rates seem to be on higher side. Nevertheless considering the huge amount of litigation, possibly this could be a good way forward."