Safe Harbours – Can they calm the troubled waters for captive service providers for MNCs in India ?

1. Background

The Indian Government had enacted safe harbours in the Indian transfer pricing (TP) regulations vide the Finance (No. 2) Act, 2009. However, no safe harbour rules were prescribed thereafter. Consequently, the enactment of safe harbours had largely remained ineffective in India till the recent turn of events in the last two months. The initial release of the draft safe harbour rules in August, 2013; and the subsequent moderation of the same through the release of the final safe harbour regulations in the last week of September, finally ended four years of intense anticipation and speculation amongst taxpayers.

The release of the safe harbour regulations is presumably a part of the series of initiatives undertaken by the Indian Government to promote a fairer taxation environment in India to boost the sagging sentiments of foreign investors. The recent dwindling of foreign investments has eroded India's image as the sole sanctum of foreign investors in Asia. In the recent years, the neighbouring economies of Vietnam, Philippines, Malaysia, Bangladesh and Indonesia have promised of similar coves, which had taken India to tumultuous heights in the last two decades. Although India and China still lead the pack, tax and economic policies adopted by India in the recent past had compelled taxpayers to stall major expansion plans in India, a loss, which India cannot afford to bear.

In the last few years, TP has become one of the most controversial tax issues in India with protracted high stake litigations. A large section of these disputes relate to determination of arm's length mark-up for contract

* Rahul K Mitra, National Leader, Transfer Pricing Practice PwC, India, E-mail : rahul.k.mitra@in.pwc.com.

** Soumitra K Chakraborty, Manager, Transfer Pricing Practice PwC, India, E-mail : soumitra.chakraborty@in.pwc.com.

service providers. Apart from these, there are larger disputes raging on classical TP issues like marketing intangibles, choice of remuneration model, etc., which stem from the reluctances of taxpayers, Revenue and Judiciary to embark upon detailed analyses of functional, asset and risk profiles, proper characterisation of entities, selection of tested parties and TP methodology, etc; and they require more focussed attention for arriving at optimal solutions.

The introduction of safe harbour in India was designed with a view to reduce litigation in TP, arising out of judgmental errors[1]. Thus, the efficacy of safe harbours in India can be ascertained by analysing the likelihood of taxpayers adopting these safe harbours; and their role in abatement of TP disputes or judgmental errors in TP disputes in India, as originally envisioned in the Finance (No. 2) Bill, 2009. In light of the above, the authors have outlined contemporary guidelines propounded by the OECD and UN, as well as the existing framework of safe harbour rules in select countries, in order to analyse the adequacy safe harbours enacted by India.

2. International Guidance on Safe Harbours

A safe harbour in a TP regime is a provision that applies to a defined category of taxpayers or transactions that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general TP rules. Prices established under a safe harbour would be automatically accepted by the tax administrations that have expressly adopted safe harbour rules. The OECD TP Guidelines originally[2] downplayed the utility of safe harbours in resolving TP disputes. The 1995 version expressed concerns that the introduction of unilateral safe harbours could potentially denude the application of arm's length principles by compelling enterprises to perversely price its controlled transactions in jurisdictions adopting the safe harbours. Despite the general apathy shown by the 1995 version towards application of safe harbours, a survey[3] conducted in 2010 by OECD's committee on Fiscal Affairs on administrative aspects of TP across forty one countries, revealed that safe harbour provisions, in some form or other, were enacted by around sixteen countries. The survey findings indicated that contrary to the initial apprehension of the OECD on the utility of safe harbours, these rules have survived in a number of countries. The survey findings also suggested that taxpayers and tax authorities viewed that the relative benefits of a meticulously drafted safe harbour far outweighed the related concerns.

The 2010 plebiscite triggered the release of revised section[4] in 2013 on safe harbours in the OECD Guidelines. The report acknowledged that an increased number of countries viewed that the benefits of safe harbours surpassed the related concerns, provided the rules were carefully targeted and prescribed. The report also observed that the utility of safe harbours are most apparent when they are directed at taxpayers involved in low-risk transactions. The benefits of safe harbours, as put forth by the OECD, were that of simplifying/reducing compliance, providing certainty to taxpayers, and facilitating re-direction of tax administrative resources to complex/high risk transactions/taxpayers. The report also identified several concerns surrounding implementation of safe harbours. Those may be in the form of possible contravention of arm's length principles, risk of double taxation and double non-taxation, inappropriate tax planning and inequitable treatment of taxpayers, etc. The OECD recommended that the risks of double taxation and double non-taxation, and inappropriate tax planning, may be largely eliminated by adopting safe harbours on a bilateral or multilateral basis, through agreements between competent authorities of the countries. The said release added that the agreements could define a category of taxpayers and/or transactions to which safe harbour provisions could apply; and pricing parameters that would be accepted by the contracting countries. Furthermore, the OECD recommended that where safe harbours are adopted unilaterally, the country adopting the safe harbour should be prepared to consider modification of the safe-harbour outcome under mutual agreement procedures (MAP) to mitigate the risk of double taxation. The key message promulgated by the OECD was the adoption of bilateral and multilateral safe harbours by nations as recourse to potential double taxation triggered by unilateral safe harbours.

The UN TP Manual[5] broadly resound the OECD view on safe harbours and rejoins that a safe harbour is suited for an attractive option for developing countries, mainly because they can provide predictability and ease of administration of the TP regime by a simplified method of establishing taxable profits. The Manual also adds that a safe harbour is available at the election of a taxpayer and cannot be used at its disadvantage.

The excerpts of the safe harbour provisions prevalent in some of the countries are narrated below in order to understand the nature and objective of the safe harbours in the respective nations :

Mexico

The Mexican safe harbour is targeted towards the maquiladoras, i.e. companies engaged in toll manufacturing for foreign companies, operating in Mexico. Under the regime, maquiladoras are deemed to comply with the TP regulations; and not constitute permanent establishments, if they report profits of :

- 6.9% of operating assets; or
- 6.5% of operating costs; whichever are higher.

Maquiladoras not opting for the safe harbour had recourse to normal TP documentation and audits or to enter into Advanced Pricing Agreements (APA). However, the recent Reform Package presented by the Mexican Government proposes to restrict the choice of Maquiladoras between the safe harbour and an APA. The Mexican safe harbour regime was a part of the various simplification measures undertaken by the Mexican Government to facilitate the establishment of the maquiladoras, which became an integral feature of the socio-economic policy[6] of Mexico.

Brazil

The Brazilian Government introduced TP rules specifically aiming at two areas, over which it felt that it had little control, namely import and export transactions conducted by multinationals with foreign related parties. The rules required that a Brazilian company substantiate its inter-company import and export prices on an annual basis. Brazil's TP rules do not adopt the internationally accepted arm's length principle. Instead, it defines the maximum price ceilings for deductible expenses on inter-company import transactions and minimum gross income floors for inter-company export transactions.

The rules stipulate safe harbour gross margin of 20% for importer distributors operating in Brazil; and 60% for importer manufacturers. In case of exports, the safe harbours were provided to taxpayers salvaging 90% of the average domestic sales price. The Brazilian Government enacted a provisory measure in April 2013 which considerably alters the above rules. The fixed profit margin rules of 20%/60% to be used when applying the local version of the resale price less margin method for imports were revisited and, to a certain extent, made less aggressive[7] by providing sector specific margins.

United States

The 482 Service Regulations issued by the IRS in 2009 allow taxpayers to charge certain services at cost to their overseas related parties (Service Cost Method) provided it meets all the following conditions:

- The service must be a Specified Covered Service or a Low Margin Covered Service. A specified service is a controlled services transaction that the Commissioner specifies by revenue procedure. Low margin covered services are controlled services transactions for which the median comparable mark up on total services costs is less than or equal to 7%.
- The service should not be an Excluded Services, namely denoting categories of transactions like manufacturing, production, extraction, research, development etc. which are not covered services. In general parlance, the excluded services would comprise economically significant activities in the overall value chain.
- Need to use business judgment, in the sense that services which do not contribute significantly to key competitive advantages, core capabilities or fundamental risks of success or failure of the renderer, the

recipient, or both, would be eligible for such rules.

Singapore

The Inland Revenue Authorities of Singapore acknowledge that the conduct of a comprehensive analysis for the purpose of demonstrating compliance with the arm's length principles might not be practical for certain routine transactions. Therefore, the Revenue allows practical alternatives to assist taxpayers in complying with the arm's length principles, including accepting 5% mark-up for certain routine support activities.

Australia and New Zealand

Australia and New Zealand have similar safe harbour rules. The safe harbour extends to services that are not integral to the profit-earning or economically significant activities of the group or are below a certain threshold (de minimis). The safe harbours are lower of actual or cost plus 7.5% for services received and greater of cost plus 7.5% or actual for services rendered.

It is evident from the above that most of countries enlisted above (e.g. US, Singapore, Australia etc.) offer safe harbour for back-office transactions, which do not contribute significantly to the country's economy or to the competitive advantage of an enterprise. The primary objective of safe harbour regulation in these countries is to reduce time and resource allocation of tax authorities as well as taxpayers from low risk transactions. It is also pertinent to note that many of these nations, being global/regional headquarters to large MNEs, the tax authorities have been generally intrigued by more sensitive issues like migration of intangibles, business restructuring etc. and thus too satiated to pluck low hanging fruits like services. The select exceptions to the above rule are Mexico, wherein safe harbours were enacted as an economic reform to incentivize maquiladoras; and Brazil, which had enamored its TP regulations entirely in a safe harbour.

As against the above, India had introduced safe harbours with a view to reduce litigation and disputes in TP, caused due to judgmental errors around comparable benchmarking even for significantly core and critical functions and activities, which contribute to the economy of the country; and not for reducing administrative time and energy in assessing routine services.

3. Safe Harbour Provisions of India

The Indian safe harbour rules, devised for abatement of TP disputes, enabled eligible taxpayers to opt for the same, for periods not exceeding five years, by filing the relevant form with the Assessing Officer (AO); and submitting a statement regarding the quantum of international transactions, nature of services and the safe harbour rate for the relevant financial year. The rules also allow taxpayers to opt out of the safe harbours anytime within the five-year period, after due intimation to the AO.

Though the safe harbour rules have been framed to cater to various classes of transactions and taxpayers, namely –

(*a*) provision of services under contract service provider model, namely by assuming minimal risks, in the fields of software development (IT) services; information technology enabled services (ITeS); knowledge process outsourcing (KPO) services; and research and development (R&D) services;

(*b*) outbound loans and corporate guarantees; and

(*c*) manufacture and export of auto components;

the authors have restricted the discussions to only the transactions and taxpayers covered in category (a), as above, which really have been the stimulus to the economic growth of the country since the commencement of globalisation in the early nineties; and which have troubled foreign MNCs the most in terms of disputes in TP in the last eight rounds of TP assessments.

The safe harbour rates, as measures of operating profit/total cost, for different categories of services, which are provided under contract service provider model, are as follows :

IT and ITeS	20% for annual transaction value upto INR 5 billion (US$ 80 million appx); and 22% for annual transaction value in excess of INR 5 billion
KPO	25% without any turnover threshold
R&D for generic pharmaceutical drugs	29% without any turnover threshold
R&D for IT	30% without any turnover threshold

4. Will safe harbours reduce TP litigation in India?

The authors are of the view that the herald of safe harbour as a tool for reducing TP disputes in India is far flung from reality. Much of the disputes around contract service providers in the fields of IT, ITeS, KPO and R&D, arise due to the uniqueness of the Indian TP regulations in its use of arithmetic mean and a band around the mean, as against the use of median and inter-quartile range adopted by most other TP regimes.

The authors had earlier analysed[8] comparable sets widely used for determination of arm's length prices for IT and ITeS companies in the TP assessments for fiscal year (FY) 2006-07, i.e. relevant to the assessment year 2007-08. The IT set comprised of 26 companies with current year operating profitability in the form of operating profit/total cost, ranging from 1.38% to 60.23%, with an arithmetic mean of 25.04%. Similarly, the ITeS set comprised of 27 companies with current year operating profitability in the form of operating profit/total cost, ranging from 13.55% to 113.49%, with an arithmetic mean of 30.24%.

Thus, any captive IT or ITeS company with an operating margin of less than 19% and 24% respectively, namely after considering the band of 5% around the arithmetic mean, as prevalent during the material time, would have failed to satisfy the arm's length test for FY 2006-07, as per the country-wide comparable benchmarking sets adopted by the Indian Revenue.

It may be pertinent to highlight that the lower quartiles of the same IT and ITeS sets were at about 14% and 12% respectively. Therefore, the use of inter-quartile range on the same comparables would have enabled captive taxpayers with an operating profitability of 15%, being the intuitive mark-up for most captive IT and ITeS companies, to comply with the arm's length standard. The analysis was re-run on the ITeS comparables used in the TP assessment cycle relating to FY 2007-08, i.e., relevant to the assessment year 2008-09. The lower limit of arm's length price, computed with reference to the 5% tolerable limit around the arithmetic mean, was again observed to be at 19%, while the lower quartile was at 9%.

These analyses vindicate that, but for the ingenuity of the Indian TP regulations, a large fraction of taxpayers falling within the bracket of 15% of operating profitability or even lower, would have remained unscathed, even if one were to otherwise accept the selection of comparables by the Indian Revenue for the IT and ITeS sets, which itself left enough room for debate. Therefore, the introduction of inter-quartile range and median would have better addressed the TP disputes in India and obviated the need for safe harbours, as the pre-dominant objective of introducing safe harbours is to reduce TP litigations in India.

Some may attribute the adoption of arithmetic mean by the Indian Revenue, for the purposes of computing the arm's length price, to the brevity of comparable data available in public databases in the formative years of transfer pricing in India, which inhibited the usage of quartiles. It is observed that Prowess™, a public database widely used for the purposes of comparable benchmarking analyses in India, reported only 8,067 companies in the year 2002, as compared to 25,949 companies in 2011. Presently another database used for benchmarking analyses, namely Capita line Plus™, provides data of around 1,000 additional companies over and above the companies provided in Prowess™. Thus, brevity of data can no longer be the reason or cause for not adopting the more sophisticated approach of the inter-quartile range by the Indian Revenue, as several of the other developing economies, let alone the developed ones, have advocated the usage of inter-quartile range and median for the purposes of computing the arm's length range.

The safe harbour rates proclaimed by India are still not reasonable enough to entice large captive service providers, since opting for safe harbour rates in India might result in such taxpayers facing economic double taxation, as Revenue authorities of the headquarter countries are unlikely to accept the high mark-ups under the unilateral safe harbour rules of India. Furthermore, as the taxpayers adopting safe harbours would be precluded from seeking refuge of MAP, as expressly provided in the safe harbour regulations, the risk of double taxation at headquarter countries is aggravated.

It needs to be understood that safe harbour rates are not arm's length prices, 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. Whether or not a taxpayer might 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 @ 42% (after duly factoring in the effect of the dividend distribution tax), which it might bear in India, in exchange of having peace and serenity, in a scenario where it could have got resolution from the Tribunal or in an APA at say 13 or 15%, may not be quite large, being INR 21 to 29 million or US$ 350,000 to 490,000 approx. Thus, even if the Revenue of the country of the headquarter 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.

However, for the larger players, having cost base of INR 2 or 5 billion or even higher, the situation might change, 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. For KPO and contract R&D sectors, the safe harbour rates are much higher, i.e. 25% and 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 headquarters of such companies would agree to such high margins being awarded to their Indian captive service providers.

Thus, larger captive players in the fields of IT, ITeS, 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 and not bilateral; and that the safe harbour rules specifically debar taxpayers from availing of the benefits of MAP under tax treaties to mitigate economic double taxation.

Such players would have to pursue normal TP documentation and assessments, with the chances of facing protracted litigation, where the Revenue Officers might use the safe harbour rates as "floors" and not "caps" for concluding the TP assessments. Reliefs can be expected only at the level of the Tribunals. The Indian Government might have done better to offer lower safe harbour rates to boost exports at minimal compliance cost of taxpayers, particularly in the current need to strengthen the weakening rupee.

The authors acknowledge that the framework of domestic tax policies is a sovereign right; and India may decide to continue with the doctrine of arithmetic mean and abysmally high safe harbour rates, even at the cost of being most unique amongst other TP regimes. In such a case, India should strive to implement bilateral safe harbours or at least enable the availing of MAP facilities to placate hapless taxpayers who would succumb to their perils in India and simultaneously face the hatchet abroad. With the whiff of warmth in the air, which promises of thawing of Indo-US fiscal relations and the OECD chartering the path for bilateral safe harbours, India may consider negotiating bilateral safe harbours with major economic allies to at least ensure that the taxpayers adopting safe harbours are not meted with double taxation issues at their headquarters.

Unless that is done, large taxpayers should seriously consider the option for APAs for obtaining up-front resolution, given the pragmatic and positive attitude, which the APA team has already shown in their dealings with applicants ever since the APA programme got live last year. 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 practices followed by other countries; and 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.

With the bilateral negotiations with US, being the source country with the maximum outsourcing work to India, expected to open up in the near future, post the recent deliberations between the Competent Authorities of US and 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 fields of IT, ITeS, KPO, R&D, etc; or at least unilateral APAs till the doors of bilateral APAs are thrown wide open, for better up-front resolution of TP in India.

1. Para 96 of Finance Minister's Budget 2009-10 speech released on July 9, 2009
2. Chapter IV of OECD TP Guidelines for Multinational Enterprises and Tax Administrations adopted in 1995.
3. Multi-Country Analysis of Existing TP Simplification Measures released in July 2012.
4. Revised Section E on Safe Harbours in Chapter IV of the TP Guidelines released in May 2013.
5. Chapter III of the United Nations Practical Manual on TP released in May 2013.
6. Review of Trade and Investment Liberalisation Measures by Mexico and Prospects of Future United States - Mexico Relations
7. Brazil's New Transfer Pricing Reform authored by Dr. Napoleao Dagnese
8. Fundamental Reforms Needed for Indian TP Regulations - Too "Mean" To Be Good; published in International Taxation in December 2011