

## Introduction

The Central Board of Direct Taxes (*'CBDT'*), vide notification number 46/2017, made amendments to the Safe Harbour Rules (*'SHRs'*) issued in September 2013. The safe harbour programme issued in September 2013, would have met with a better response, had there been lesser ambiguity in the classification of services and had the margin percentages been more streamlined. This amendment to the existing SHRs should help in achieving multiple objectives, viz:

- i. reducing transfer pricing disputes;
- ii. providing certainty to taxpayers;
- iii. aligning safe harbour margins with industry standards; &
- iv. enlarging the scope of safe harbour transactions.

## Applicability

The revised SHRs are applicable from April 1, 2017, i.e. Assessment Year (*'AY'*) 2017-18 and shall continue to remain in force for two immediately succeeding years thereafter, i.e. upto AY 2019-2020. The earlier SHRs were applicable from AY 2013-14, and for four immediately following AYs, i.e. upto AY 2017-18. Taxpayers eligible under the present safe harbour regime upto AY 2017-18 shall also have the right to choose the safe harbour option most beneficial to them.

## Key highlights

1. A new category of transactions being *'Receipt of Low Value-Adding Intra-Group Services'* has been introduced, which inter-alia covers the following:
  - Services in the nature of support services;
  - Services that are not a part of the core business of the multinational enterprise group, i.e., such services neither constitute the profit-earning activities nor contribute to the economically significant activities of the multinational enterprise group;
  - Services that are not in the nature of shareholder services or duplicate services;
  - Services that neither require the use of unique and valuable intangibles nor lead to the creation of unique and valuable intangibles;
  - Services that neither involve the assumption or control of significant risk by the service provider nor give rise to the creation of significant risk for the service provider; &
  - Services that do not have reliable external comparable services that can be used for determining their arm's length price.

The revised SHRs also prescribe a list of ten services, namely, Research and Development (*'R&D'*), Manufacturing and Production, Information Technology (*'IT'*), Software Development, Knowledge Process Outsourcing (*'KPO'*), Business Process Outsourcing (*'BPO'*), Sales, marketing and distribution, purchasing activities of raw materials/other materials used in the manufacturing or production process, extraction, exploration, or processing of natural resources, financial transactions, insurance and reinsurance, that would be excluded from the purview of low value-adding intra-group services.

The classification for the services falling within the purview of low value-adding intra-group services is largely in line with the guidelines issued by the Organisation for Economic Co-

operation and Development ('OECD') under the Base Erosion and Profit Shifting ('BEPS') Action Plans 8-10.

The revised SHRs also lay down a requirement for the applicant to get the following aspects certified by an accountant:

- method of cost pooling;
- exclusion of shareholder costs and duplicate costs from cost pool; &
- the reasonableness of the allocation keys used for allocation of costs.

The definition of an accountant has also been incorporated in the revised SHRs, which is in line with the definition provided in section 288 of the Income-tax Act, 1961.

2. The revised SHRs have introduced an upper turnover threshold of INR 200 crore for the following transactions:

- Provision of software development services;
- Provision of ITES;
- Provision of KPO services;
- Provision of contract R&D (*wholly or partly relating to software development*); &
- provision of contract R&D (*wholly or partly relating to generic pharmaceutical drugs*).

For AY 2017-18, since the taxpayers have an option to choose from old or new rules, even the taxpayers with relevant international transactions in excess of INR 200 crore can opt for safe harbour as per the old rules.

3. The revised SHRs have rationalised the safe-harbour rates for the following services:

Service	Old rate per the SHRs issued in September 2013	New rate per the revised SHRs of June 2017
IT services & ITES	20-22%	17-18%
KPO services	25%	18%, 21%, 24% depending on the ratio of employee cost to operating cost
Contract R&D ( <i>for IT and generic pharmaceutical drugs</i> )	29-30%	24%

4. The revised SHRs have prescribed safe harbour rates for loans advanced to AEs denominated in foreign currency, based on London Inter-bank Offer Rate ('LIBOR'). The revised SHRs have also prescribed the spreads to be considered over the applicable base rates. This spread would be dependent on the credit rating of the overseas borrower, subject to such credit ratings being approved by CRISIL. Please refer to Page 4 of this document for the rates notified by the SHRs.
5. The application of the revised safe-harbour rates for KPO services is dependent upon the ratio of the employee cost to total cost of the taxpayers. The revised SHRs have comprehensively defined the term 'employee cost' to inter-alia include the following:

- Salaries and wages;
- Gratuities;
- Perquisites;
- Bonus or commission;
- Lumpsum payments received on termination of service;
- Expenses incurred on contractual employment of persons performing tasks similar to those performed by the regular employees;
- Recruitment;
- Relocation; &
- Training expenses.

The term also includes outsourcing expenses, to the extent of employee cost, wherever ascertainable, embedded in the total outsourcing expenses (*where not ascertainable, 80% of the total outsourcing expenses shall be deemed to be the employee cost embedded in the total outsourcing expenses*).

6. The revised SHRs have amended the definition of the term ‘operating expenses’ to include the following:

- Costs relating to Employee Stock Option Plan (‘ESOP’) provided for by the AE;
- Reimbursement to AE for expenses incurred by the AE on behalf of the taxpayers (*subject to such reimbursements being at cost*); &
- Amounts recovered from AE which relate to normal operations of the taxpayers (*subject to such recoveries being at cost*).

The revised SHRs have also amended the definition of operating revenue to now include costs relating to ESOPs provided for by the AE.

### Revised safe-harbour rates

International transaction	Safe harbour rates – Old rules [Applicable from AY 2013-14 to AY 2017-18]	Safe harbour rates – New rules [Applicable from AY 2017-18 to AY 2019-20]
Provision of software development services	Operating profit margin to operating expense: <ul style="list-style-type: none"> <li>• where the aggregate value of such transactions <math>\leq</math> INR 500 crore - not less than 20 percent;</li> <li>• where the aggregate value of such transactions <math>&gt;</math> INR 500 crore - not less than 22 percent.</li> </ul>	Operating profit margin to operating expense: <ul style="list-style-type: none"> <li>• where the aggregate value of such transactions <math>\leq</math> INR 100 crore- not less than 17 percent</li> <li>• where the aggregate value of such transactions <math>&gt;</math> INR 100 crore but <math>&lt;</math> INR 200 crore – not less than 18 percent.</li> </ul>
Provision of ITES	Operating profit margin to operating expense:	Operating profit margin to operating expense:

	<ul style="list-style-type: none"> <li>• where the aggregate value of such transactions <math>\leq</math> INR 500 crore - not less than 20 percent;</li> <li>• where the aggregate value of such transactions <math>&gt;</math> INR 500 crore - not less than 22 percent.</li> </ul>	<ul style="list-style-type: none"> <li>• where the aggregate value of such transactions <math>\leq</math> INR 100 crore- not less than 17 percent</li> <li>• where the aggregate value of such transactions <math>&gt;</math> INR 100 crore but <math>&lt;</math> INR 200 crore – not less than 18 percent.</li> </ul>
Provision of KPO services	Operating profit margin to operating expense not less than 25 percent	<p>The value of international transaction <math>\leq</math> INR 200 crore and the operating profit margin to operating expense is:</p> <ul style="list-style-type: none"> <li>• Not less than 24 percent, if the employee cost to operating expense is at least 60 percent</li> <li>• Not less than 21 percent, if the employee cost to operating expense is greater than 40 percent or more but less than 60 percent; or</li> <li>• Not less than 18 percent, if the employee cost to operating expense does not exceed 40 percent.</li> </ul>
Advancing of intra-group loans where the amount of loan is denominated in Indian Rupees	<p>Interest rate equal to or greater than the base rate of State Bank of India ('SBI') as on June 30, of the relevant previous year:</p> <ul style="list-style-type: none"> <li>• plus 150 basis points where the amount of loan is <math>\leq</math> INR 50 crore</li> <li>• plus 300 basis points where amount of loan is <math>&gt;</math> INR 50 crore</li> </ul>	<p>The threshold of INR 50 crore has been removed.</p> <p>Interest rate not less than the one-year marginal cost of funds lending rate of State Bank of India as on April 1 of the relevant previous year plus:</p> <ul style="list-style-type: none"> <li>• 175 basis points where the Associated Enterprise ('AE') has CRISIL credit rating between AAA to A or its equivalent;</li> <li>• 325 basis points where AE has CRISIL credit rating of BBB-, BBB or BBB+ or its equivalent;</li> <li>• 475 basis points where AE has CRISIL credit rating between BB to B or its equivalent;</li> <li>• 625 basis points where AE has CRISIL credit rating between C to D or its equivalent; or</li> <li>• 425 basis points where credit rating of AE is not available</li> </ul>
Advancing of intra-group loans where the amount of loan is denominated in foreign currency	-	<p>The threshold of INR 50 crore has been removed.</p> <p>The interest rate not less than the six-month London Inter-Bank Offer Rate of</p>

		<p>the relevant foreign currency as on September 30 of the relevant previous year plus</p> <ul style="list-style-type: none"> <li>• 150 basis points where AE has CRISIL credit rating between AAA to A or its equivalent;</li> <li>• 300 basis points where AE has CRISIL credit rating of BBB-, BBB or BBB+ or its equivalent;</li> <li>• 450 basis points where AE has CRISIL credit rating between BB to B or its equivalent;</li> <li>• 600 basis points where AE has CRISIL credit rating between C to D or its equivalent; or</li> <li>• 400 basis points where credit rating is not available</li> </ul>
Providing corporate guarantee	<ul style="list-style-type: none"> <li>• where the amount guaranteed <math>\leq</math> INR 100 crore - Commission or fee of 2 percent or more per annum</li> <li>• where the amount guaranteed <math>&gt;</math> INR 100 crore, and the credit rating of the borrower, by a Securities and Exchange Board of India (SEBI) registered agency is of the adequate to highest safety - Commission or fee of 1.75 percent or more per annum.</li> </ul>	<p>The differential rates of 2 percent and 1.75 percent have been moderated down to a standard rate of 1 percent irrespective of the amount guaranteed.</p> <p>However, the requirement for the credit rating of the borrower to be certified by a SEBI registered agency and such credit rating to be of adequate to highest safety still remains for amount guaranteed exceeding INR 100 crore.</p>
Provision of contract R&D services wholly or partly relating to software development	Operating profit margin to operating expense not less than 30 percent.	The operating profit margin of not less than 24%, where the value of the international transaction is $\leq$ INR 200 crore.
Provision of contract R&D services wholly or partly relating to generic pharmaceutical drugs	Operating profit margin to operating expense not less than 29 percent.	The operating profit margin of not less than 24%, where the value of the international transaction is $\leq$ INR 200 crore.
Manufacture and export of core auto components	Operating profit margin to operating expense of not less than 12 percent	Operating profit margin to operating expense of not less than 12 percent

Manufacture and export of non-core auto components	Operating profit margin to operating expense of not less than 8.5 percent	Operating profit margin to operating expense of not less than 8.5 percent
Receipt of low value-adding intra-group services		Aggregate value of such transactions (including a mark-up not exceeding 5 percent), does not exceed INR 10 crore.  Method of cost pooling, exclusion of shareholder costs and duplicate costs from cost pool and the reasonableness of the allocation keys used for allocation of costs to be certified by an accountant.

### KNAV comments

1. The revised SHRs is a good move by the government to instil faith in the minds of the taxpayers that the government is committed to its objective of reducing transfer pricing disputes, providing certainty to taxpayers, aligning safe harbour margins with industry standards and enlarging the scope of safe harbour transactions. The safe harbour programme issued in September 2013, would have met with a better response, had there been lesser ambiguity in the classification of services and had the margin percentages been more streamlined.
2. Inclusion of low value-adding intra-group services under the ambit of the revised SHRs is a welcome move. Although the definition of low-value intra-group services is largely in line with the OECD BEPS Action Plan 8-10, better clarity is required in terms of what falls under the ambit of 'core business' and what would constitute 'services that do not have reliable external comparable services that can be used for determining their arm's length price'. Rules/further clarity in this regard is awaited.
3. The revised SHRs have set an upper turnover threshold of INR 200 crore for IT, ITES, KPO and contract R&D services, owing to which, these revised SHRs would be applicable only to small and medium enterprises. While this may lead to a steady rise in the number of small and medium enterprises opting for safe harbour with a view to reduce protracted litigation, the large enterprises having international transactions in excess of INR 200 crore, are not eligible for opting for safe harbour starting AY 2018-19, and will either need to opt for the Advance Pricing Agreement ('APA') programme to achieve tax certainty, or will need to undergo protracted litigation year-on-year.
4. The revised SHRs provide tax certainty only for a period of three years, as against the APA programme that provides tax certainty for five years (*in case roll-back is not sought*) and nine years (*in case roll-back is sought*). Accordingly, it would have been more beneficial for the taxpayers, if the revised SHRs would have offered tax certainty for a period of five years.