



INDIA TRANSFER PRICING - SAFE HARBOUR PROVISIONS



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I. INTRODUCTION & BACKGROUND:

Given the fact, that the total quantum of transfer pricing adjustments made during the year were INR 70,016 Crores, Safe Harbour Rules have been designed to reduce the incidence of transfer pricing assessments and disputes. The Central Board of Direct Taxes in its press release dated September 18, 2013 issued the final "safe harbour rules".

A Safe Harbour is a provision of a statute or a regulation that specifies that certain transactions will be deemed not to violate a given rule. The rules provide minimum operating profit ratios in relation to operating expenses a taxpayer is expected to earn for certain international transactions.

Definition of Operating Expenses & Operating Revenues:

- "**Operating expenses**" mean costs incurred in the previous year by the assessee in relation to the international transaction during the course of its normal operations including depreciation and amortisation expenses relating to the assets used by the assessee; interest expense; provision for unascertained liabilities; pre-operating losses arising on account of foreign currency fluctuations; extra-ordinary expenses on account of transfer of assets or investments; expense on account of income-tax; and other expenses not relating to normal operations of the assessee
- "**Operating revenues**" mean income earned by the assessee in the previous year in relation to the international transaction during the course of its normal operations including interest income; income arising on account of foreign currency fluctuations; income on transfer of assets or investments; refunds relating to income-tax; income written back; extraordinary incomes; and other incomes not relating to normal operations of the assessee.

II. ELIGIBLE INTERNATIONAL TRANSACTIONS & SAFE HARBOUR RATIOS

The definition of eligible transactions along with the safe harbour ratios are given below:

1. Software Development Services include:

- Business application software and information system development services using new methods and existing software tools;
- Support for existing systems;
- Converting or translating computer languages;
- Adding user functionality to application programmes;
- Debugging of systems;

- Adaptation of existing software; or
- Preparation of user documentation

Eligible Transaction	Safe Harbour Ratio
Software Development Services	Operating profit to expense margin
Aggregate Value of transactions < Rs. 500 crores	>20%
Aggregate Value of transactions > Rs. 500 crores	>22%

2. Information Technology Enabled Services include:

- Back office operations
- Call centres or contact centre services;
- Data processing and data mining;
- Insurance claim processing;
- Legal databases;
- Creation and maintenance of medical transcription excluding medical transcription services;
- Translation services;
- Payroll;
- Remote maintenance;
- Revenue accounting;
- Support centres;
- Website services;
- Data search integration and analysis;
- Remote education excluding education content development;
- Clinical database management services excluding clinical trials.

Eligible Transaction	Safe Harbour Ratio
Information Technology Enabled Services	Operating profit to expense margin
Aggregate Value of transactions < Rs. 500 crores	>20%
Aggregate Value of transactions > Rs. 500 crores	>22%

3. Knowledge Process Outsourcing Services include services provided in the form of assistance or use of information technology requiring application of knowledge and advanced analytical and technical skills, namely:

- Geographic information system;
- Human resources services;
- Engineering and design services;
- Animation or content development and management;
- Business analytics;
- Financial analytics;
- Market research

Eligible Transaction	Safe Harbour Ratio
Knowledge Process Outsourcing Services	Operating profit to operating expense margin >25%

4. Intra-group loans advanced by taxpayer to Wholly Owned Subsidiaries.

refer to loans,

- Sourced in Indian rupees;
- Not advanced by an enterprise, being a financial company including financial institution or an enterprise engaged in lending or borrowing in the normal course of business; and;
- Does not include credit line or any other loan facility which has no repayment

Eligible Transaction	Safe Harbour Ratio
Intra Group Loans to Wholly Owned Subsidiaries	Interest rate equal to or greater than the rate of State Bank of India (SBI) as of the relevant previous year:
Amount of loan < 50 crores	Plus 150 basis points
Amount of loan > 50 crores	Plus 300 basis points

5. Explicit corporate guarantee extended by taxpayer to Wholly Owned Subsidiaries.

respect of any short term or long term borrowing.

Explicit corporate guarantee does not include letter of comfort, implicit corporate performance guarantee or any other guarantee of similar nature.

Eligible Transaction	Safe Harbour Ratio
Explicit corporate guarantee to Wholly Owned Subsidiaries	Commission Fee
Amount guaranteed < 100 crores	>2.00%
Amount guaranteed > 100 crores	>1.75%

6. Contract research and development services wholly or partly relating to development include:

- Research and development producing new theorems and algorithms in theoretical computer science;
- Development of information technology at the level of operating systems, programming languages, data management, communications and software development tools;
- Development of Internet technology;
- Research into methods of designing, developing, deploying or maintaining software;
- Software development that produces advances in generic approaches to transmitting, storing, retrieving, manipulating or displaying information;
- Experimental development aimed at filling technology knowledge gaps necessary to develop a software programme or system;
- Research and development on software tools or technologies in specific computing (image processing, geographic data presentation, character recognition, artificial intelligence and such other areas);
- Upgradation of existing products where source code has been made available to the principal.

Eligible Transaction	Safe Harbour Ratio
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Contract research & development services relating to software development	Operating profit to operating exp >30%
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7. Contract research and development services wholly or partly relating to pharmaceutical drugs

"Generic pharmaceutical drug" means a drug that is comparable to a drug approved by the regulatory authority in dosage form, strength, route of administration, quality and performance characteristics, and intended use.

Eligible Transaction	Safe Harbour Ratio
Contract research & development services relating to Generic pharmaceutical drugs	Operating profit to operating exp >29%

8. Manufacture of Auto components

a) Core auto components include,

- Engine and engine parts, including piston and piston rings, engine valves, cooling systems and parts and power train components;
- Transmission and steering parts, including gears, wheels, steering axles and clutches;
- Suspension and braking parts, including brake and brake assemblies, shock absorbers and leaf springs

b) Non core auto components include, auto components other than core auto components

Eligible Transaction	Safe Harbour Ratio
Manufacture of auto components	Operating profit to operating margin
Core	>12%
Non core	>8.5%

III. Procedure to opt for Safe Harbour route

Any taxpayer who has entered into an eligible international transaction and wishes to exercise the option to be governed by the safe harbour rules is required to file a Form 3CEFA (Form 3CEFA) and furnish it before the due date for filing the tax return. Form 3CEFA is a statement of self declaration and needs to be signed by the person who is authorized to sign the tax return. The option for safe harbour validly exercised shall continue to remain in force for the period specified in Form 3CEFA or for a period of five years, whichever is less.

IV. Applicability and Validity of Safe Harbour Rules

The safe harbour rules shall be applicable for five years beginning from FY 2012-13. Taxpayers can elect to be governed by the safe harbour rules for all or any part of the period.

V. KNAV Comments

We feel that whilst these rules are much desired and welcome, the margins prescribed in the safe harbour need to be brought in line with market reality. Very few, if any, businesses will be able to achieve such margins and therefore the practical usage of these newly notified safe harbour rules will be difficult for most taxpayers. Taxpayers should study these rules to adopt sound business principles such as what constitutes Operating Expenses and Operating Revenues. The rules provide an insight into the revenue department's thinking on classification of services and their expectations on margins. Thus, taxpayers should distinguish their profitability

conducting diligent FAR analysis and documenting the benchmarking, comp
related adjustments.

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