UNDERSTANDING INDIAN SAFE HARBOUR RULES - AN INDEPTH ANALYSIS

Nithya Srinivasan & Krithika Valliappan

Introduction

In the ever-changing field of international taxation, transfer pricing (TP) remains one of the most intricate and scrutinized areas. Countries across the globe have implemented measures to ensure that multinational enterprises (MNEs) are taxed appropriately within their jurisdictions. As transfer pricing compliances become increasingly detailed, one measure introduced by various countries for simplification of TP requirements for certain class of transactions is the establishment of "safe harbour rules," which provide a degree of certainty and simplicity for taxpayers in the often-complex field of transfer pricing.

On the same lines, India had introduced its safe harbour rules in 2013, and has later made necessary changes in subsequent years. Even in the Union Budget for 2024-25, the finance minister had mentioned that the scope of safe harbour rules would be expanded and revised to make it more attractive.

This article explores into the concept of safe harbour rules, evolution of the safe harbour rules in India, discovers the specifics of India's framework, and assesses its impact on the taxpayers.

Overview

Safe Harbour (SH) is a dispute resolution mechanism, which relieves taxpayers from certain obligations, which are generally imposed on the taxpayers by the provisions under Section 92C and 92CA of the Indian Income Tax Act, 1961. The SH rules prescribe the arm's length terms and conditions for certain routine/ non-complex transactions.

The objective of introducing SH rules was to significantly reduce the disputes between the taxpayers and the tax authorities. These rules provide a straightforward approach and were intended to reduce the burden on taxpayers. Hence, SH Rules provide certainty to taxpayers and protects them from a detailed TP Scrutiny.

Evolution of Safe Harbour Rules in India

After its enactment vide the Finance (No. 2) Act 2009, the first set of SH rules were notified on 18th September 2013 – Rules 10TA to 10TG and Form 3CEFA (for international transactions) and Rules 10TH and 10THA to 10THD and Form 3CEFB (for specified domestic transactions). The rules were initially applicable

for a period of five years from the assessment year (AY) 2013-14 to AY 2017-18 and later extended.

Over time, recognizing the low uptake and the need for more practical thresholds, the Indian government revised these margins and expanded the scope of SH rules in subsequent years. These revisions aimed to make the SH framework more attractive and accessible to small taxpayers, thereby reducing compliance and reducing disputes. The evolution of SH rules reflects a broader effort to balance taxpayer interests with regulatory objectives, contributing to a more stable and predictable transfer pricing environment in India.

Safe Harbour rules for Specified Domestic Transactions are applicable to a company engaged in the business of supply, transmission or wheeling of electricity and a co-operative society engaged in the business of purchase of milk and milk products.

Who can opt for Safe Harbour?

Eligible Assessee has been defined under Rule 10TB and such person should have exercised a valid option for application of SH rules in accordance with rule 10TE. For certain eligible transactions viz., software development services, ITeS, KPO and R&D services, the eligibility criteria which are mentioned in the SH rules were

aligned with the Circular 6/2013 issued by the Central Board of Direct Taxes (CBDT). For the purposes of identifying an eligible assessee, that bears insignificant risk for provision of services, the following conditions should be satisfied:

1. The foreign principal performs most of the economically significant functions involved, and provides the strategic direction and framework, either through its own employees or through its other associated enterprises, while the eligible assessee carries out the work assigned to it by the foreign principal;

2. The capital and funds and other economically significant assets including the intangibles required, are provided by the foreign principal or its other associated enterprises, and the eligible assessee is only provided a remuneration for the work carried out by it;

3. The eligible assessee works under the direct supervision of the foreign principal or its associated enterprise which not only has the capability to control or supervise but also actually controls or supervises the activities carried out through its strategic decisions to perform core functions as well as by monitoring activities on a regular basis;

4. The eligible assessee does not assume or has no economically significant realised risks, and if a contract shows that the foreign principal is obligated to control the risk but the conduct shows that the eligible assessee is doing so, the contractual terms shall not be the final determinant;

5. The eligible assessee has no ownership right, legal or economic, on any intangible generated or on the outcome of any intangible generated or arising during the course of rendering of services, which vests with the foreign principal as evident from the contract and the conduct of the parties.

Eligible International Transactions

SH rules can be applied on specific categories of transactions which has a set of targeted operating profit margins. Thus, the tax administration would accept, with limited scrutiny, transfer prices within the SH parameters. Eligible international transactions are defined under rule 10TC. 'Eligible international transaction' means an international transaction between the eligible assessee and its associated enterprise, either or both of whom are non residents. They are listed below:

1. Provision of software development services;

2. Provision of information technology enabled services;
3. Provision of knowledge process outsourcing services
4. Advancing of intra-group loans;
5. Providing corporate guarantee;
6. Provision of contract research and development services wholly or partly relating to software development;
7. Provision of contract research and development services wholly or partly relating to generic pharmaceutical drugs;
8. Manufacture and export of core auto components;
9. Manufacture and export of non-core auto components; and
10. Receipt of low value-adding intra-group services

Procedure for applying Safe Harbour Rules

In order to apply Safe harbour rules, the procedure as mentioned under Rule 10TE has to be followed, a summary of which is given below:

1. Application in Form 3CEFA to be furnished to the AO on or before the due date for furnishing of Return of Income

2. Upon receipt of the Form 3CEFA, the AO shall verify whether the assessee is an eligible assessee and the transaction is an eligible international transaction.

3. In case the AO doubts the eligibility, he shall make a reference to the TPO for determination of the eligibility. Reference to be made to the TPO within 2 months from the end of the month in which Form No. 3CEFA is received by the AO.

4. The TPO may require the assessee to furnish necessary information or documents by notice in writing within specified time.

5. If the TPO finds that the option exercised is invalid, he shall serve an order regarding the same to the assessee and the AO. An opportunity of being heard is provided to the assessee before passing the order. TPO needs to pass the said order within 2 months from the end of the month in which reference from the AO has been received.

6. If the assessee objects the same, he shall file an objection within 15 days of receipt of order with the Commissioner, to whom the TPO is subordinate.

7. On receipt of objection, the Commissioner shall pass appropriate orders after providing an opportunity of being heard to the assessee. The Commissioner needs to pass the said order within 2 months from the end of the month in which objection is filed by the assessee.

8. Where the option is valid, the AO shall verify the TP in respect of the eligible international transactions is in accordance with the circumstances specified in rules 10TD(2) or (2A) and if the same is not in accordance with the said circumstances, the AO shall adopt the operating profit margin or rate of interest or commission specified in the said sub-rules, as applicable.

9. If no reference is made or no order has been passed within the specified time limit, the option for SH exercised by the assessee shall be treated as valid.

Reasons for Low Adoption of Safe Harbour by many Taxpayers

Despite the potential benefits and revision of the SH rules, adoption of dispute resolution mechanism has been largely skewed towards Advance Pricing Agreement (APA) and Mutual Agreement Procedure (MAP). There are several reasons why taxpayers are hesitant to opt for SH rules. The SH rules often require companies to adhere to profit margins that are higher than what they might achieve under normal market conditions. For many businesses, particularly in competitive industries like IT and ITeS, these margins are considered commercially unviable, leading them to not evaluate SH as an option.

SH rules are rigid, offering redefined benchmarks with

little room for negotiation or adjustment based on the specific circumstances of a company. This lack of flexibility can be a deterrent, especially for businesses with unique operational models or those operating in volatile markets. The SH rules apply only to certain types of transactions and industries, such as IT services, ITeS, Auto, intra-group loans etc. Companies with diverse or complex transactions that fall outside the scope of SH rules may find them irrelevant or insufficient for their needs.

While SH rules are designed to reduce scrutiny, they do not completely eliminate the possibility of audits or inquires, especially if the company engages in transactions outside the scope of SH rules, it is still possible for tax authorities to audit other transactions.

Aspects under Safe Harbour which are not utilised/ undervalued

For the below categories of transactions, one should reevaluate SH option after considering the effectiveness and resourcefulness of this option vis-à-vis other alternate dispute resolution mechanisms.

1. IT & ITeS companies with revenue less than 200 crores can evaluate their transactions and can opt for Safe Harbour instead of choosing APA. The targeted margins under these two

dispute resolution mechanisms varies only by a marginal percentage. The Companies can benefit from the short and simple audit process of SH and avoid the increased cost of resources, reduce the timeline for closure.

2. Companies which pay management charges to its group entities are under litigation constantly. One can opt for SH and eliminate the process of a need benefit test documentation. Under SH these documents are not required and the process is very simple. Companies with management fees less than 10 crores and where the mark-up is 5% can benefit from this provision. Where the intragroup charges exceed the threshold limit, the taxpayer can analyse if the said intragroup charges can be grouped / segmented based on the services covered under the SH Rules and opt for SH Rules for the eligible services.

3. Indian headquartered company which extends corporate guarantee to banks on behalf of their subsidiary can opt for SH and pay a flat 1% on the amount guaranteed. In case of litigation, at the first level the expectation is as high as 2% to 3% on the amount guaranteed. If they opt for this mechanism, no further back-end benchmarking analysis is required.

Expectations / Recommendations on updates in Indian SH Rules

As the government expects to amend the safe harbour rules for improving the acceptance by taxpayers, some of the recommendations are listed below:

- **Introduction of royalty as a covered transaction:** Royalty expenses are among the most frequently contested international transactions. Like low-value-adding activities, certain safeguards could be implemented, such as setting an upper limit on the value of royalty transactions and requiring a Chartered Accountant's certificate to verify aspects like the calculation of royalty payments, among others.

- **Arm's length mark-up for knowledge process outsourcing services:** It has been traditionally linked to the ratio of employee costs to total costs. However, with the post-pandemic shift to a hybrid work model, businesses have seen a reduction in overhead expenses like office rentals and employee transportation. As a result, this ratio may increase even though the assessee continues to perform the same functions. Therefore, revisions to these ratios can be anticipated.

- **Widening the coverage of IT, ITeS and KPO services:** The SH Rules have an upper cap of INR 200 crores for IT, ITeS and KPO services. This threshold limit can be expanding with certain safeguards such as employee cost related ratios linked with profitability.

Further, the Finance Minister stated that the SH rates would be introduced for foreign mining companies which are into raw diamonds in India.

Global SH Practices

It would be good to evaluate the Safe Harbour practices adopted by other countries. They are summarised below:

Australia

The Australian Taxation Office provides safe harbour guidelines for low-value-adding intra-group services, including a fixed mark-up of 5% on costs. This simplifies compliance for companies involved in routine services.

Brazil

Brazil is known for its unique transfer pricing regime, which includes specific fixed margins for different types of transactions. Safe harbour provisions can be applied to certain low-value-adding intercompany service transactions. The department of federal revenue (RFB) has set a

safe harbour with a 5% gross margin based on the total costs of these low-value-adding services.

Mexico

Mexico offers safe harbour provisions specifically for maquiladoras (manufacturing operations in free trade zones). These rules allow maquiladoras to use a simplified profit margin method to determine the taxable income attributable to the Mexican subsidiary. The safe harbour margin is set at 6.5% of operating costs or 6.9% of the total value of assets, whichever is higher.

Netherlands

Netherland provides a safe harbour regime for intercompany financing transactions. A fixed mark-up of 100 basis points over the risk-free interest rate is allowed for certain low-risk financial transactions.

Singapore

The Inland Revenue Authority of Singapore (IRAS) offers Safe Harbour provisions to reduce the compliance burden for businesses in certain related party transactions. These provisions include a 5% mark-up on costs for routine support services, such as administrative, payroll, and IT support, provided to group companies. These services must meet specific criteria under the TP Rules to qualify. Additionally, for related party loans not

exceeding SGD 15 million, an annually published indicative margin can be applied, simplifying transfer pricing compliance without the need for detailed Transfer Pricing Documentation (TPD).

Conclusion

India's safe harbour rules have been a good step in the direction of simplifying compliances in the country's transfer pricing regime. They have provided much-needed certainty and simplicity for taxpayers, while also reducing the administrative burden on tax authorities.

As SH has received a lukewarm response, one can expect some developments on this front soon in terms of the notification as mentioned during the Budget 2024. Adjusting the profit margins to more commercially realistic levels would make the SH rules more attractive to companies. Further simplification of the compliance requirements under SH rules, such as reducing the documentation burden (Rule 10D) and streamlining the application process, could encourage more businesses to opt in.

Providing additional incentives for opting into SH rules, such as reduced penalties for minor non-compliance or quicker resolution of transfer pricing

disputes, could make the SH regime more appealing. These could make Safe Harbour rules more practical, attractive, and beneficial for a broader range of taxpayers, thereby increasing their adoption and effectiveness.

Apart from reduced litigation and obtaining higher certainty, especially for transactions such as software development services, ITeS and KPO services, catalysed adoption of SH rules would unclog alternate dispute resolution mechanisms – Advance Pricing Agreement, which has significant applications related to the IT space.

(The authors are part of a VSTN Consultancy Private Limited, Transfer Pricing boutique firm and can be reached at snithya@vstnconsultancy.com and krithikav@vstnconsultancy.com).