

Extension of Safe Harbour Rules to AY 2022-23: Is it Harboursing Industry Expectations?

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The Central Board of Direct Taxes ('CBDT') has extended the applicability of Safe Harbour Rules ('SHR') to AY 2022-23 vide notification no. 66/2022 dated June 17, 2022 i.e. the current SHR being deemed to come in force from April 01, 2022.

SHR is a mechanism provided to the taxpayers at their option, to seek certainty and mitigate risk of dispute (pertaining to arm's length nature of the international transactions) which otherwise results into protracted litigation. SHR, in simple terms, provides circumstances in which the income-tax authorities shall accept the transfer price declared by the taxpayer in respect of eligible international transactions (i.e. cross border transactions with overseas related parties), without challenging and/or conducting any audit of such declared transfer price.

SHR has been prescribed in 2013 by introducing rules 10TA to 10TG in the Income-tax Rules, 1962 ("The Rules"). However, it seems that the taxpayers gave a meagre response to the SHR possibly due to higher mark-up / pricing metrics prescribed in the SHR which is to be followed by the taxpayers to obtain certainty through this optional 'Alternate Dispute Avoidance' mechanism. Hence, the CBDT rationalized the margins in response to the industry expectations as well as widened the scope of eligible international transactions in the revised SHR in 2017. Such revised SHR were applicable for AY 2017-18 to AY 2019-20. The below table summarises the key mark-up / pricing data prescribed by SHR.

Sl. No.	Eligible international transaction	Existing prescribed threshold for value of international transaction	Existing prescribed margin to be declared
1	Provision of software development services	≤ 100 crores > 100 crores but ≤ 200 crores	Not less than 17% of operating cost Not less than 18% of operating cost
2	Provision of information technology enabled services	≤ 100 crores > 100 crores but ≤ 200 crores	Not less than 17% of operating cost Not less than 18% of operating cost

Sl. No.	Eligible international transaction	Existing prescribed threshold for value of international transaction	Existing prescribed margin to be declared
3	Provision of knowledge process outsourcing services	<p>≤ 200 crores; and the Employee Cost in relation to the Operating Expense: is at least 60%</p> <p>is at least 40% but less than 60%</p> <p>is less than 40%</p>	<p>Not less than 24% of operating cost</p> <p>Not less than 21% of operating cost</p> <p>Not less than 18% of operating cost</p>
4	Advancing of intra-group loans denominated in INR and in foreign currency	One-year marginal cost of funds lending rate of State Bank of India as on 1st April of the relevant previous year plus basis points differing as per the credit ratings and the loan currency.	
6	Providing corporate guarantee	NA	1% or more p.a. on guaranteed amount
7	Provision of contract research and development services - software development	≤ 200 crores	Not less than 24% on operating cost
8	Provision of contract research and development services - generic pharmaceutical drugs	≤ 200 crores	Not less than 24% on operating cost
9	Manufacture and export of core auto components	NA	Not less than 12% on operating cost
10	Manufacture and export of noncore auto components	NA	Not less than 8.5% on operating cost
11	Receipt of low value adding intra-group services	≤ 10 crores	Not exceeding 5%
12	Attribution of profit to PENA (Introduced in finance bill 2020 to expand the scope of safe harbour rules)	NA	NA

Many stakeholders in the Industry were expecting certain modifications to be made to the SHR for last couple of years, due to the impact of various events unfolded during COVID pandemic disruptions. However, the mark-up % (and other critical pricing metrics) prescribed under the SHR (under Rule 10TD sub rule 1 and 2A) issued for AY 2017-18 have been kept the same for all subsequent AYs (including now for AY 2022-23 vide notification no. 66/2022 dated June 17, 2022).

Taxpayers fraternity has been expecting reduction in the mark-up numbers prescribed in the SHR primarily for the software services and IT enabled services. Currently these service providers have to declare a margin of 17% or more on costs (if the turnover is less than 100 crore) and 18% or more on costs (if the turnover is more than 100 crore but less than 200 crore) to be eligible under the SHR. **With the Start-up ecosystem grooming and transitioning to its next growth phase, many taxpayers operating in/ related to such ecosystem involving cross border rendering of these services to its associated enterprises were expecting a further reduction in these prescribed margins/mark-ups may be with a lower revenue threshold as well (for example, there was an expectation that companies with turnover of upto 50 crore are allowed to be eligible to opt for SHR with 13%-15% margin declared on costs).**

Further, with respect to the KPO services, the SHR has prescribed incremental mark-up rates (24%, 21% and 18%) basis the salary costs percentage of total costs (>60%, <60 to 40% and <40%) under the assumption that higher the salary costs as a percentage of total costs higher is the value attached to the services rendered (through such employees) and thereby warranting for higher mark-up on total costs. **Considering the trend of Work From Home ('WFH') adopted by many companies during and post COVID period, coupled with many companies giving up / reducing the office space capacity, the salary costs has become the single largest component even for any routine KPO services. Therefore, in the current WFH environment, it may not be appropriate to consider salary costs as a percentage of total costs as a conclusive indicator of the high-end nature of the KPO services.** Taxpayers were expecting that the SHR for AY 2022-23 will make appropriate changes to plug such anomaly.

For cross border services rendered by taxpayers to its related parties pertaining to contract research and development services wholly or partly relating to software development or generic pharmaceutical drugs, the SHR has prescribed margin of 24% on total costs. For taxpayers engaged in manufacturing and export of core auto components and non-core auto components on contract basis, the SHR has prescribed margin of 12% and 8.5% on total costs. **Due to changing global dynamics, many jurisdictions are offering themselves as a competitive alternative to MNCs to set-up their global service centers ('GSC') and global manufacturing units ('GMU'), and thus it was expected that the SHR will be modified to improve the competitiveness quotient of the India SHR (impacting these GSCs and GMUs) by rationalizing the current prescribed margins.**

Currently, only interest on loans given to the wholly owned subsidiary could be covered under the SHR and it was also expected that SHR should be extended to other associated enterprises who may not be the wholly owned subsidiaries. Further, an expectation from the industry was that the interest on loan availed by the Indian taxpayers from its associated enterprises would also be covered under SHR. **Also, it was expected that the SHR for AY 2022-23 would chalk out the framework for interest computation on loans keeping in mind the phasing out of LIBOR and countries being inclined to adopt their alternative reference rates. However, the SHR for AY 2022-23 has nothing to offer / address on these expectations.**

Since the time, the Income-tax provision has allowed for the certainty to be obtained for profit attribution to the Permanent Establishment through SHR and Advance Pricing Agreements ('APA'), the industry at large is expecting a detailed framework for profit attribution to be prescribed as a part of the SHR. **As the existing SHR has been merely extended to AY 2022-23, such expectation will take more time to get fulfilled.**

Additionally, new age technologies of current digital era have changed the way commercial activities are carried on all over the globe (without there being need to have a physical presence in all jurisdictions) and at the same time, it has also made it difficult for the governments of almost all tax jurisdictions to avoid tax base erosion and to ensure equitable distribution of taxes on such commercial activities. Fallout of such scenario is that governments of various jurisdictions (especially countries having large user/market base) implemented unilateral tax measures especially on digital transactions. While OCED's actions in the form of Pillar One and Pillar Two is expected to streamline some of these aspects (related to tax base erosion and distribution of taxes) **but it will be limited to only those enterprises who are crossing the prescribed high value thresholds.** It would be worthwhile to explore as to how the SHR, along with other dispute avoidance tools like APA etc., can be applied / adopted as an additional / complimentary tool to attract the remaining MNC players (being an integral part of / closely interlinked to the digital ecosystem) to explore obtaining certainty and thereby protect the tax base in an efficient manner.

While APA has evolved and enhanced its effectiveness as an 'Alternate Dispute Avoidance' over last few years and typically unfolding value for various large corporations, SHR as an 'Alternative Dispute Avoidance' mechanism / tool need to be made more attractive for the mid-size to small corporations by making structural changes to the SHR as discussed above. This will then mitigate the risk of commencement of the litigation cycle of large number of mid-size and small corporations, which unfortunately consumes humungous energy and resources for Taxpayers as well as Tax Administrators.

Certainty on taxes is a very important ingredient for enhancing and sustaining the investment climate in

any jurisdiction. Providing meaningful options to obtain tax certainty to investors in India through mechanism like SHR would aid in enhancing the investment climate (to attract more investments in India) and consequently result in more employment opportunities in India.