CONFIDENTIAL

Second Report of the Committee to Review Taxation of Development Centres and the IT Sector

Safe Harbour

13/10/2012

Foreword

The Committee set-up by the Government to examine some of the issues relating to taxation of income of persons engaged in the IT sector is glad to furnish its second report. The first report, submitted on 14th September 2012, had addressed some of the taxation issues confronting the IT Sector and the Development Centres. This report recommends Safe Harbour rules for IT and ITES sectors. Two more reports on Safe Harbour will follow in due course.

While furnishing this report, I must duly acknowledge the role played by its members, namely, Ms. Anita Kapur, DGIT (Administration), Delhi and now elevated to the post of Member, CBDT, Ms. Rashmi Saxena Sahni, DIT (Transfer Pricing-I), Delhi and Mr. Dinesh Kanabar, Tax Expert in analyzing the various data and showing a rare commitment and devotion.

I must also acknowledge with gratitude the important role played by the three senior officers of the Department, namely Shri Subhakant Sahu, Shri D. Prabhakar Reddy and Shri Sobhan Kar, Addl. Commissioners of Income-tax, in assisting the Committee in its deliberations and bringing into consideration relevant issues from time to time.

I would also like to place on record the Committee's appreciation of the efforts put in by the officers and staff of the DGIT (Admn.) in providing logistical assistance to the Committee in discharging its responsibilities.

N. Rangachary,
Chairman
13th October, 2012

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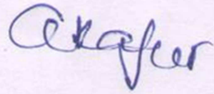
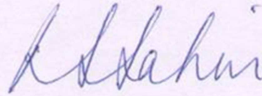
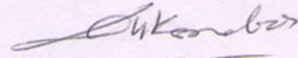
Second Report of the

Committee to Review Taxation of Development

Centres and the IT Sector

(Safe Harbour in IT & ITES Sectors)

Submitted by

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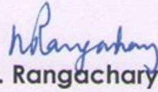

N. Rangachary

Former Chairman

CBDT & IRDA

Chairman

PART -1: INTRODUCTION

1.1 Prime Minister's Office issued a press release on July 30, 2012 (Annexure-I), stating that the Hon'ble Prime Minister had constituted a Committee to Review Taxation of Development Centres and the IT Sector under the Chairmanship of Shri N Rangachary, former Chairman CBDT & IRDA. The Committee submitted its first Report to the Government on 14th September, 2012 covering issues listed in the terms of reference of the Committee, except the following :

"Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector."

1.2 The rationale for entrusting the Committee with this task was explained in the Press Release (ibid) as follows:

"As far as Safe Harbour provisions are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer"

1.3 The Committee was advised to suggest Safe Harbour Rules individually sector-by-sector in a staggered manner and submit draft Safe Harbour provisions for three sectors/sub-activities each month beginning with the first set of suggestions by 30 September 2012 and finalise all Safe Harbour provisions by 31 December 2012.

1.4 Vide Office Memorandum dated 13th September, 2012 (Annexure-II), the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors / activities:

i) IT Sector

ii) ITES Sector

iii) Contract R&D in the IT and Pharmaceutical Sector

iv) Financial Transactions – Outbound loans

v) Financial Transactions – Corporate Guarantee

vi) Auto Ancillaries – Original Equipment Manufacturers

1.5 The timelines for submission of recommendations of the Committee on Safe Harbours were also revised as follows vide the aforesaid OM:

i. First Report by 15-10-2012

ii. Second Report by 15-11-2012

iii. Third Report by 31-12-2012

Accordingly, this committee is submitting in this report, its recommendations for Safe Harbour rules for IT and ITES sectors.

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PART -2: DELIBERATIONS IN THE COMMITTEE

2.1 Section 92CB of the Income-tax Act, inserted by the Finance (No. 2) Act, 2009, w.r.e.f. 1-4-2009, extracted below, provides the legislative framework for the Safe Harbour Rules:

"**Power of Board to make safe harbour rules.**

92CB. (1) The determination of arm's length price under section 92C or section 92CA shall be subject to safe harbour rules.

(2) The Board may, for purposes of sub-section (1), make rules for safe harbour.

Explanation- For the purposes of this section, "safe harbour" means circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee."

2.2 The then Finance Minister, in his budget speech gave the following rationale for authorizing CBDT to make Safe Harbour Rules:

> *"In order to further improve the investment climate in the country, we need to facilitate the resolution of tax disputes faced by foreign companies within a reasonable time frame. This is particularly relevant for such companies in the Information Technology (IT) sector. I, therefore, propose to create an alternative dispute resolution mechanism within the Income Tax Department for the resolution of transfer pricing disputes. To reduce the impact of judgmental errors in determining transfer price in international transactions, it is proposed to empower the Central Board of Direct Taxes (CBDT) to formulate 'Safe Harbour' rules."*

2.3 The same justification was reiterated in the Explanatory Memorandum to the Finance (No. 2) Act, 2009, as under:

> *"Section 92C of the Income-tax Act provides for adjustment in the transfer price of an international transaction with an associated enterprise if the transfer price is not equal to the arm's length price. As a result, a large number of such transactions are being subjected to adjustment giving rise to considerable dispute. Therefore, it is proposed to empower the Board to formulate Safe Harbour rules i.e. to provide the circumstances in which the Income-tax authorities shall accept the transfer price declared by the assessee.*
> *This amendment will take effect from 1st April, 2009"*.

2.4 Suggestions and data to frame Safe Harbour provisions for IT (Software) and ITES sectors were invited from the following stakeholders:

1) Director General of Income-tax (International Taxation) through the Central Board of Direct Taxes;
2) NASSCOM (National Association of Software and Service Companies)
3) CII (Confederation of Indian Industry)
4) FICCI (Federation of Indian Chambers of Commerce and Industry)
5) ASSOCHAM (Associated Chambers of Commerce and Industry of India)
6) PHDCCI (PHD Chamber of Commerce & Industry)
7) ICAI (Institute of Chartered Accountants of India)
8) PWC (Price Waterhouse Coopers)
9) E&Y (Ernst & Young)
10) Deloitte Haskins & Sells
11) KPMG
12) BMR Advisors

13) Vaish & Associates, Delhi
14) T. P. Ostwal & Associates, Mumbai
15) Infosys Technologies Ltd.
16) Wipro Ltd.
17) Tata Consultancy Services Ltd.
18) HCL Technologies Ltd.
19) Accenture
20) Microsoft
21) IBM
22) Dell

2.5 The Income Tax Department and industry stakeholders were asked to provide the details relating to the value of international transactions, the margins shown by the assessee, and the margins adopted by the Transfer Pricing Officers (TPOs) across the country for Assessment Years 2006-07, 2007-08 and 2008-09 in regard to IT-Software and ITES segments.

2.6 The Committee considered the views of those stakeholders who responded, international practices and also took note of the earlier report on Safe Harbours submitted in August 2010, by a Committee formed by CBDT under the then DGIT (International Taxation).

2.7 **International Practices**

The Committee has considered the following Discussion Papers/Reports on Safe Harbour put in the public domain for discussion by OECD in June 2012:

i. Discussion Draft - Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Draft Sample Memoranda of Understanding for competent authorities to establish bilateral Safe Harbours - 6th June to 14th September 2012.

ii. Multi-Country Analysis of Existing Transfer Pricing Simplification Measures – 2012 Update.

2.8 The OECD discussion Paper on Proposed Revision of the Section on Safe Harbours in Chapter IV has also highlighted the benefits and concerns of Safe Harbours, which are summarised below.

2.9 **Why Safe Harbour Rules?**

- Simplifying compliance.
- Providing certainty that the price of controlled transactions will not be reviewed by the tax administration, thereby reducing disputes.
- Relieving a tax administration from audit of taxpayers opting for Safe Harbour, thereby enabling better utilisation of its resources.

2.10 **Why opposition to Safe Harbours? - Alerts by OECD**

- Difficult to establish satisfactory criteria for determining Safe Harbours as Safe Harbours may produce prices or results inconsistent with the arm's length principle.
- The extensive research necessary to set Safe Harbour parameters would jeopardise one of the purposes of Safe Harbour i.e. administrative simplicity.
- Safe Harbour may result in unfair distribution of tax between tax jurisdictions as the taxpayers may raise the prices above the arm's length prices to qualify for the Safe Harbour.
- Safe Harbour may cause double taxation, nullifying the objectives of certainty and simplicity.

- Safe Harbour may result in surrender of a portion of the tax administration's discretionary power in favour of automatic rules.
- Administrative burden saved by the country offering the Safe Harbour would be shifted to the foreign jurisdictions if they, in order to protect their tax base, test the consistency of Safe Harbour with their own Transfer Pricing rules.
- Tax planning opportunities for the taxpayers in cases where taxpayers have better than average profitability would cause significant revenue loss for the country offering the Safe Harbour.
- Safe Harbour can allow shifting of taxable income to low tax countries or tax havens.
- Safe Harbour raises equity and uniformity issues i.e., similar taxpayers subjected to different tax treatment and could entail discrimination and competitive distortions.

2.10.1 The Committee has considered the concerns of the OECD as highlighted above and is of the view that the concerns highlighted above, though valid to a certain extent, are either manageable or can be discounted considering the benefits of Safe Harbours.

2.10.2 The first concern of Safe Harbours producing results that are inconsistent with the arm's length principle can be addressed by properly designing the Safe Harbour Rules. In any case, there could be inconsistent results emanating from regular Transfer Pricing audits too due to the fact intensiveness of such audits, the lack of proper comparables and the lack of adequate and accurate data and judgmental errors by the officers. Tax Administration can reasonably choose practicality over consistency if the objective is to minimise disputes. The second argument about requirement of extensive research pre-supposes exact arm's length price for all activities being the basis of Safe Harbour rules. This concern can be met if these rules

are confined to certain activities prioritised as per policy imperatives and a certain variation from arm's length price is permitted. The principle of variation up to a certain % has a precedence in section 92C of the Income Tax Act. The third concern of unfair distribution of tax between different tax jurisdictions and a higher burden on the jurisdiction not offering the Safe Harbour, ignores the reality that tax policy is a sovereign function and individual tax administrations cannot be obligated to ensure "fairness" across countries or to simplify tasks of other jurisdictions. There is neither an international law fixing tax rates for different countries nor a ban on opting for simple tax rules. The fourth concern regarding the risk of double taxation on a taxpayer has to be assessed by the taxpayer itself in the elective or optional regime of Safe Harbours. The advantages of certainty and simplicity would be important considerations for the taxpayer while deciding to elect or opt for the Safe Harbour provisions. As regards the fifth concern of revenue loss for the tax jurisdiction adopting Safe Harbour Rules, due to such Rules failing to capture more than the average profitability, it can be safely presumed that the tax jurisdiction may be willing to risk a possible revenue loss in a few cases by factoring in the benefit of additional revenue that it may be able to generate by better utilization of its scarce resources, improved cash flows on account of reduced litigation and increased business due to improved investment climate. The argument that Safe Harbour rules may allow shifting of taxable income to low tax countries pre-supposes gaps in rules. Properly constructed rules will minimize such opportunities. The perceived threat that Safe Harbour rules mean surrender of discretionary power in favour of automatic rules may actually be an opportunity as a robust set of rules replacing discretion may be advantageous for a tax administration by lessening administrative and compliance costs and reducing disputes. Finally, the issue of discriminatory treatment and threat of a competitive distortion may not be so critical as to outweigh the advantages of Safe Harbours. In a developing country like India, where the opportunities are inequal, many

incentives and presumptive rates which may be inherently inequitable are already part of the tax law .

2.11 **Analysis of Safe Harbours in other countries**

Key findings of the OECD Multi-Country Analysis of Existing Transfer Pricing Simplification Measures paper showed that 16 out of 33 respondents,[1] including India, had put Safe Harbour measures in place. The survey also indentified 69 types [2] of simplification measures providing a balance between compliance costs and size and complexity of the transactions.

2.12 **Types of Safe Harbours**

2.12.1 Safe Harbour 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 transfer pricing rules. These may be of various kinds, such as:

a) Simplified transfer pricing method specifying the circumstances under which such method would be applicable.

b) Specifying arm's length range / rate for international transactions of specified category.

c) Safe Harbour interest rates for inbound and outbound loans separately.

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[1] OECD Multi-Country Analysis of Existing Transfer Pricing Simplification Measures, June, 2012 – p.13

[2] OECD Multi-Country Analysis of Existing Transfer Pricing Simplification Measures, June, 2012 – p.7

d) Exemption from applicability of transfer pricing rules based on turnover of the taxpayer, value of international transactions or value of investment made in fixed assets.

e) Exemption from transfer pricing documentation requirements based on turnover of the taxpayer, value of international transactions or value of investment made in fixed assets.

f) Exempting a defined category of taxpayers or transactions from the application of all or a part of the general transfer pricing rules, based on minimum or range of profitability indicators. For example, many countries have Safe Harbours for non-core or low value-added services.

g) Eligible taxpayers complying with the Safe Harbour provisions may be relieved from burdensome compliance obligations, including some or all associated transfer pricing documentation requirements.

h) A rebuttable presumption could be established under which a mandatory pricing target would be established by a tax authority, subject to a taxpayer's right to demonstrate that the target price is inconsistent with the arm's length principle, when applied in the taxpayer's case.

i) Fixed margins or a range of Safe Harbour margins for certain specified sectors with reference to a method.

2.12.2 It can be seen from the international experience of Safe Harbours [3] that existing Safe Harbours are mainly directed at taxpayers or transactions of the following nature:

- Low value adding intra-group services;
- Loans;

[3] OECD Report on Multi-Country Analysis of Existing Transfer Pricing Simplification Measures, June, 2012

- Small and Medium Enterprises (SMEs); and
- Small transactions.

2.12.3 Summary of Country-wise Analysis of Simplification Measures

Sl. No.	Country	Eligible taxpayers / Transactions	Type of simplification measure	Option / Exclusion
1	Australia	Low value adding intra-group services	Safe Harbour arm's length range	Option
		Small transactions	Safe Harbour arm's length range	Option
2	Austria	Low value adding intra-group services	Safe Harbour arm's length range	Option
		Loans	Simplified transfer pricing method	Option
3	Japan	Low value adding intra-group services	Simplified transfer pricing method	Option
		Loans	Simplified transfer pricing method	Option
4	Mexico	Others	Safe Harbour arm's length range	Option
5	Netherlands	Low value adding intra-group services	Simplified transfer pricing method	Option
6	New Zealand	Low value adding intra-group services	Safe Harbour arm's length range	Option
		Loans	Simplified transfer pricing method	Option
7	Singapore	Low value adding intra-group services	Safe Harbour arm's length rate	Option
8	Slovenia	Loans	Safe Harbour interest rate	Option
9	South Africa	Loans	Safe Harbour interest rate	Option
10	United States	Loans	Safe Harbour interest rate	Option
		Low value adding intra-group services	Simplified transfer pricing method	Option

2.12.4 Further, the Committee also took note of the fact that Safe Harbour rules are introduced, usually, with an underlying objective to address specific needs of a particular country. For example, Australia, New Zealand and Singapore introduced Safe Harbour rules to reduce administrative rigours relating to relatively low value transactions, both for the taxpayers and the revenue authorities. In case of USA, the recently promulgated Services Regulations (2009) provide for charging for certain services at costs (i.e., without any mark-up). Given the large number of multinational companies headquartered in USA, these rules were promulgated mainly to ensure that the US headquartered companies were charging out all the relevant costs that were incurred centrally for the benefit of the entire group.

2.12.5 The Committee also considered in detail the provisions as provided for by Mexico, an OECD member country. Mexico introduced Safe Harbour rules for "Maquiladora" entities (contract manufacturers) primarily to attract investment in its border areas with USA. Exports account for a large portion of the manufacturing sector in Mexico and the vast majority of export manufacturing is conducted by Mexican companies known as "Maquiladoras" or "Maquilas", which operate under temporary importation programs, known as "Maquiladora" programs, issued under Mexico's "Maquiladora" decree (now also known as the Decree for the Development of the Manufacturing, "Maquiladora" and Export Services Industry or IMMEX Decree). Mexico recognised that export manufacturing is highly mobile and has sought to encourage multinational companies to locate their export manufacturing operations in Mexico. Tax relief granted to "Maquiladora" operations has always been an important means by which the Mexican Government has attempted to attract and retain export manufacturing.

2.12.6 On December 24, 2010, new amendments to the Decree for the Promotions of the Manufacturing, "Maquiladora" and Export Services Industry ("IMMEX Decree") were published in the Federal Official Gazette of Mexico.

The amendment to Article 33 only modifies the requirements with which a "Maquiladora" operation must comply in order to apply the special tax regime, but not the Safe Harbour transfer pricing rules regarding the profits to be declared by a "Maquiladora". [4]

2.12.7 In general terms, the new requirements for a "Maquiladora" company to apply the special tax regime are described below:

- That a transformation or repair process is performed through the "Maquiladora" operation using raw materials, parts and components provided by a foreign resident. For these purposes, the following clarifications are made:
  a) The reference to services is eliminated from the definition of Maquiladora operations, but a list of services that may be considered as transformation is included in order to continue to apply the special tax regime.
  b) The raw materials must be returned abroad, including by means of virtual operations.
- That the "Maquila" operations are carried out using machinery and equipment owned by the foreign resident that has not been owned by the "Maquiladora" company or a Mexican related party.
- New restrictions are included in order to apply and benefit from the Safe Harbour transfer pricing regulations on operations where the goods are sold within Mexico and are not documented with export customs declarations known as "Pedimentos" in Mexico. Otherwise, their activities will not be considered as "Maquila" activities.

[4] http://www.bakermckenzie.com/files/Publication/6a7bf2a0-498a-4a19-bcce-018deda234c/Presentation/PublicationAttachment/08e12d3d-1a6d-40e7-912c-b311041d580/al_mexico_amendmentsimmexdecree_dec10.pdf

With these new changes, the special tax or Safe Harbour transfer pricing regulations is applicable only to manufacturing and transformation activities (including repairs) and to a reduced number of service providers, commonly known as "service Maquilas" under certain conditions.

2.12.8 The Committee also considered in detail the provisions as provided in the Brazilian laws. Brazil introduced Transfer Pricing through Law Regulation n.9430/1996[5] and has accepted only the traditional transaction methods i.e. Comparable Uncontrolled Price (CUP) Method, Cost Plus Method (CPM) and Resale Price Method (RPM). The transfer prices for different types of transactions using RPM are prescribed, which in essence are nothing but Safe Harbours. For goods, services and rights imported from a non-resident related party, the taxpayer must prove that the corresponding costs, expenses and charges do not exceed at least the parameter price calculated in accordance with one of the three methods set forth by transfer pricing regulations in case of imports. Similarly, for goods, services and rights exported to a non-resident related party, the taxpayer must prove that the export price is equal to, or greater than, the parameter price calculated in accordance with one of the methods set forth by transfer pricing regulations in case of exports. These rules cover import and export sales to related parties and loans between intra-group entities. It has various Safe Harbours (or Parameter Prices) inbuilt in the methods specified in the Statute, which are summarized as below:

- Resale Price Method with Fixed Margins – Imports:
  - ✓ Gross Margin of 40% for the following sectors for resale in Brazil:
    - Pharmaceutical chemicals and pharmaceuticals;
    - Tobacco products;

[5] Chapter 10.1 Brazil Country Practices- Draft UN Manual put in public domain in October 2012

    - Equipment and optical instruments, photographic and cinematographic;
    - Machinery, apparatus and equipment for use in dental, medical and hospital;
    - Petroleum and natural gas (mining industry); and
    - Petroleum products (derived from oil refineries and like).
  - ✓ Gross Margin of 30% for the following sectors for resale in Brazil:
    - Chemicals (other than pharmaceutical chemicals and pharmaceuticals);
    - Glass and glass products;
    - Pulp, paper and paper products; and
    - Metallurgy.
  - ✓ Gross Margin of 20% for other sectors for resale in Brazil.

- Resale Price Method with Fixed Margins – Exports:
  - ✓ Arithmetic mean of the price of equivalent or similar goods in sales made between unrelated parties in the wholesale market of the country of destination, under similar payment and negotiation conditions, reduced by the taxes included in the price and charged by the respective country, and by a profit margin of 15 percent of total wholesale price; or
  - ✓ Arithmetic mean of the price of equivalent or similar goods in sales made in the retail market of the country of destination, under similar payment and negotiation conditions, reduced by the taxes included in the price and charged by the respective country, and by a profit margin of 30 percent of total retail price.

- Cost Plus Method with Fixed Margins – Exports
  - ✓ Arithmetic mean of the acquisition or production cost of exported goods, increased by taxes and contributions paid in Brazil and by a 15% profit margin computed on the aggregate of cost plus taxes and contributions.

- Cost Plus Method with Fixed Margins – Imports
  - ✓ Production Cost Plus Profit Method (CPL), defined as the average cost of production of equivalent or similar goods, services or rights in the country of origin increased by the taxes and fees applied to the export transaction collected by the foreign country and by a profit margin of 20%.

2.12.9 In addition to the above, there is a secondary compliance rule (herein referred to as the 'relief of proof rule') whereby a taxpayer may be relieved of the obligation to substantiate the export sales price to foreign-related persons using one of the statutory methods if it can demonstrate either of the following:

- ➢ Net income derived from inter-company export sales, taking into account the annual average for the calculation period and the two preceding years, excluding companies in low-tax jurisdictions and transactions for which the taxpayer is permitted to use different fixed margins, is at least 5% of the revenue from such sales; or
- ➢ Net revenues from exports do not exceed 5% of the taxpayer's total net revenues in the corresponding fiscal year.

If a taxpayer can satisfy the relief of proof rule, the taxpayer may prove that the export sales prices charged to related foreign persons are adequate for Brazilian tax purposes using only the export documents related to those transactions. The relief of proof rule does not apply to export transactions

carried out with companies located in low-tax jurisdictions or beneficiaries of privileged tax regimes.

2.12.10 The above analysis shows that the kind of Safe Harbour rules adopted by a country such as for core /non-core/low value added services etc. are specific to the economic circumstances and perceived needs of that country. These could be driven by the need of a country to attract Foreign Direct Investment (FDI) for increased economic activity and inclusive growth. These could be instruments for creating a positive tax environment for improving investment climate, a concern emphasized by the Government of India, while introducing Safe Harbour in the Act. Further, to bring in certainty and clarity in taxation, especially with reference to the transfer prices of MNCs operating in India, in certain sectors contributing significantly to our economy, the Finance Minister approved (as contained in the OM dated 12-09-2012 (Annexure II)) that the Committee may finalise the Safe Harbour Rules for some such sectors .The committee in its deliberations agreed that Safe Harbour rules should be provided for both core/non-core activities in the IT-Software and ITES sectors.

2.13 **Existing transfer pricing simplification practices in India**

While Rules in terms of section 92CB are yet to be framed, India does have some statutory and administrative simplification provisions in the nature of Safe Harbours inbuilt in the present transfer pricing regime. These are as follows:

- As per Section 92D of the Act, read with Rule 10D(2) of the Rules, in a case where the aggregate value of international transactions, as recorded in the books of account, entered into by the taxpayer does not exceed Rs. 1 crore, the taxpayer is not required to keep and

maintain the information and documents as prescribed under Rule 10D(1).

- Proviso to Rule 10D(4) stipulates that fresh TP documentation need not be maintained in respect of each Financial Year in respect of continuing international transactions, unless there is any significant change in the nature or terms of international transactions, in the assumptions made or in any other factor, which could influence the transfer price.
- By way of Instruction No. 3/2003, the Central Board of Direct Taxes has decided that wherever the aggregate value of international transactions exceed Rs. 5 crore, the case should be picked up for scrutiny and reference under section 92CA be made to the TPO. If there are more than one transaction with an associated enterprise or there are transactions with more than one associated enterprises, the aggregate value of which exceeds Rs. 5 crore, the transactions should be referred to the TPO. Thus, the limit of Rs. 5 crore was fixed as a Safe Harbour for scrutiny of a case by a Transfer Pricing Officer. This limit was enhanced by the CBDT to Rs. 15 crore from the A.Y 2007-08 in the Central Action Plan (CAP). However, the CBDT has been issuing instructions through CAP that specified number of cases, where the aggregate value of international transactions is below the threshold limit (Rs. 15 crore), should be scrutinised by the Assessing Officer.
- The Income-tax Act also has a Safe Harbour inbuilt in second proviso to Section 92C, which provides that if the variation between the arm's length price determined and price at which the international transaction has actually been undertaken does not exceed such percentage of the latter (5% till A.Y 2012-13 and a maximum of 3% thereafter as notified for the sector), the price at which the international transaction has actually been undertaken shall be deemed to be the arm's length price. Thus, if the price charged by the assessee in its international transactions does not vary more than 5% (a

maximum of 3% for A.Y 2013-14 onwards as notified for a sector) of the arm's length price, then price charged by the assessee is accepted.

2.14 **Methodology**

2.14.1 The committee has considered the data provided by various stake holders but has primarily relied on Departmental data. The data considered by the Committee is that pertaining to the last three audit cycles i.e., A.Y. 2006-07, 2007-08 and 2008-09, and the adjustment percentage in these three cycles is 44%, 49% and 52%, respectively. The last audit cycle completed was for A.Y. 2008-09., which was completed in financial year 2011-12. Wherever the data was incomplete or incorrect, the same has been excluded from analysis. The final sample size of the three-year Departmental data includes 737 companies in the IT (software development) sector (Annexure -III) and 409 companies in the ITES sector (Annexure- IV). The resultant cleaned-up data, in view of the Committee, is comprehensive enough to enable drawing of some reasonable conclusions.

2.14.2 Margins as declared by the taxpayers and those adopted by the TPOs have been considered by the Committee. Committee found that there is broad consistency in regard to margins declared by the taxpayers as per the records of the tax department and margins as emerging from data provided by other stakeholders. Further, data shows that margins declared overseas by Indian Companies for similar activities are very low or negative and in some cases have also been accepted by the other tax administrations.

2.14.3 The following options for designing Safe Harbour rules have been considered by the Committee:

- The category of taxpayers to be kept out of purview of TP documentation under Rule 10D(2) based on the aggregate value of international transactions.

- The category of taxpayers to be kept out of the purview of transfer pricing scrutiny by the TPO based on the aggregate value of international transactions. For example possibility of excluding Small and Medium enterprises from the applicability of TP provisions and using the definition of SMCs contained in the Companies (Accounting Standards) Rules, 2006 under the Companies Act, 1956 or the definition of SMEs by the Department of Industrial Policy and Promotion (DIPP) for this purpose:

  - ✓ Definition of SMC (Small and Medium Sized Company) as per the Companies (Accounting Standards) Rules, 2006 under the Companies Act, 1956 is as follows:-

    Small and Medium Sized Company (SMC) means, a company-

    (i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

    (ii) which is not a bank, financial institution or an insurance company;

    (iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

    (iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

    (v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

    Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

✓ Definition of SME as per Department of Industrial Policy and Promotion(DIPP), Ministry of Commerce and Industry, GoI is as follows:-

Service Enterprises: The enterprises engaged in providing or rendering of services and are defined in terms of investment in equipment. The limit for investment in plant and machinery / equipment for manufacturing / service enterprises, as notified vide S.O. 1642(E), dated.29-09-2006, are as under:

Manufacturing Sector	
Enterprises	**Investment in plant & machinery**
Micro Enterprises	Does not exceed twenty five lakh rupees
Small Enterprises	More than twenty five lakh rupees but does not exceed five crore rupees
Medium Enterprises	More than five crore rupees but does not exceed ten crore rupees
Service Sector	
Enterprises	**Investment in equipments**
Micro Enterprises	Does not exceed ten lakh rupees:
Small Enterprises	More than ten lakh rupees but does not exceed two crore rupees
Medium Enterprises	More than two crore rupees but does not exceed five crore rupees

- The category of taxpayers to be kept out of the purview of Safe Harbour based on margin, turnover or aggregate value of international transactions, etc.
- The category of taxpayers to be kept within the purview of Safe Harbours based on eligible transactions and conditions thereon.

- The category of taxpayers within the IT- Software sector and ITES sector, with both sectors clearly defined, that are to be kept within the purview of Safe Harbour based on their nature of services e.g. whether R&D services within IT- Software and ITES sector to be included or excluded.

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PART 3: RECOMMENDATIONS OF THE COMMITTEE

3.1 Keeping in view the existing provisions of the Act and the directives as contained in the press release by PMO dated 30.07.2012, the Committee recommends that Safe Harbour provisions should be applicable to enterprises in the IT-Software and ITES sectors. An enterprise eligible for Safe Harbour may be called an 'Eligible Enterprise' and all the transactions that are eligible for Safe Harbour may be called 'Eligible International Transactions'.

3.2 The Committee recommends that the Government may consider the following while framing Safe Harbour Rules for Eligible Enterprises opting for Safe Harbour in the IT-Software and ITES Sectors.

3.3 **General Recommendations**

- There should be a clear definition of what constitutes IT- Software Services and IT Enabled Services. R&D Services Sector within IT-Software sector has been identified for a separate set of Safe Harbour rules, which will be covered in the subsequent reports of the Committee.
- The taxpayer should have the option of whether to go in for Safe Harbour or not and it should not be mandatory. However, Safe Harbour should not become a rebuttable presumption for a taxpayer who opts not to go for it and has an ALP below the Safe Harbour. There has to be a directive to the Assessing Officer/TPO in this regard that they can get the international transactions bench-marked but cannot force the taxpayer to rebut the presumed ALP.
- Safe Harbour would not be available to a taxpayer whose profits are higher than the Safe Harbour margins on account of its contracted price and such a taxpayer cannot be assessed at the lower presumptive ALP corresponding to the Safe Harbour.
- Safe Harbour margins recommended may be made applicable prospectively from A.Y 2013-2014, for a period of two years.

- Further, an institutional mechanism needs to be evolved so that every two to three years, the Safe Harbour rules/margins/rates are reviewed and notified in advance so that the taxpayers can comply with such provisions with ease.
- Safe Harbour provisions may not be applicable if the eligible enterprise renders services in the nature of eligible international transactions to any Associated Enterprises (AE) located in jurisdiction as notified under section 94A of the Act.

3.4 **Specific Recommendations on threshold**

3.4.1 The existing limit of Rs. 1 crore provided under sub-rule 2 of Rule 10D was fixed more than a decade ago. NASSCOM has strongly demanded an upward revision. This upward revision is also justified to adjust for inflation. It may be mentioned that change in monetary parameters on account of inflation factor is part of our tax policy as is evident from the fact that the monetary limit for audit of accounts of certain persons engaged in business, as provided in section 44AB of Income Tax itself, has been revised upwards from Rs. 40 lakhs to Rs. 1 crore during the corresponding period.

3.4.2 **Accordingly, the Committee recommends that the exemption from maintaining information and documentation for international transactions specified at Rs. 1 crore under sub-rule 2 of Rule 10D of the Income-tax Rules be raised to Rs 5 crore as it will reduce compliance cost for small tax payers. Tax administration will have a smaller basket for picking up cases for scrutiny facilitating optimum use of its resources**

3.4.3 The present practice of authorising the AO to do transfer pricing audit in select number of cases, where the aggregate value of international transactions is less than the threshold limit (Rs. 15 crore), has reduced the

applicability of the threshold limit as a Safe Harbour while simultaneously diluting the effectiveness of transfer pricing audit.

3.4.4 **The Committee, therefore, recommends that the threshold of Rs.15 crore as an administrative Safe Harbour should be specified as a statutory Safe Harbour rule itself.**

3.5 **Specific Recommendations for framing Safe Harbour rules**

3.5.1 First step is to define the activities covered in the two sectors, which make an enterprise eligible for a Safe Harbour. **Committee recommends that following definition of activities covered in IT - Software and ITES Sectors may be adopted for Safe Harbour in these two sectors:**

3.5.1.1 **Information Technology -Software**

The IT Services include software-related activities of a routine nature, which do not involve scientific and/or technological advances or resolution of technological uncertainties. These include the following:

- Business application software and information system development using known methods and existing software tools.
- Support for existing systems.
- Converting and/or translating computer languages.
- Adding user functionality to application programmes.
- Debugging of systems.
- Adaptation of existing software.
- Preparation of user documentation.

but do not include the following:

- R&D producing new theorems and algorithms in the field of theoretical computer science.

- Development of information technology at the level of operating systems, programming languages, data management, communications software 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 for capturing, transmitting, storing, retrieving, manipulating or displaying information.
- Experimental development aimed at filling technology knowledge gaps as necessary to develop a software programme or system.
- R&D on software tools or technologies in specialised areas of computing (image processing, geographic data presentation, character recognition, artificial intelligence and other areas).[6]

3.5.1.2 **Information Technology Enabled Service (ITES)**

"Information Technology Enabled Service" means any service provided mainly with the assistance or use of Information Technology, including, but not restricted to,:

1. Back Office operations
2. Call centers or contact centre services;
3. Data processing and data mining;
4. Geographic Information System services;
5. Human Resources services;
6. Insurance Claim Processing;
7. Legal databases;
8. Creation and Maintenance of Medical Transcription;

[6] OECD – Frascati Manual – Proposed Standard Practice for Surveys on Research and Experimental Development, 2002 - Paragraphs 140 & 141.

9. Translation Services
10. Payroll;
11. Remote Maintenance;
12. Revenue accounting;
13. Support Centres; and
14. Website services
15. Data search integration and analysis
16. Remote education
17. Engineering and design services
18. Animation or content development and management
19. Business analytics
20. Financial analytics
21. Market research
22. Clinical database management services

3.5.2 Eligible International Transactions shall be the rendering of Information Technology or Software Development Services or Information Technology Enabled Services by the eligible enterprise but would not include research and development services. As per the principle enunciated by the Committee in the first report, only routine IT-Software and ITES as listed above, would be eligible for Safe Harbour as per this set of recommendations. Safe Harbour for enterprises engaged in rendering R&D services, some of which are listed in the exclusions in para 3.5.1.1, would be considered in the subsequent report of the Committee.

3.5.3 The Safe Harbours recommended in this report would be applicable to the Eligible Enterprise, in the following conditions (to be met cumulatively) and the most appropriate method would be Transactional Net Margin Method (TNMM) in such cases with the applicable mark-up as suggested by the Committee:

- The critical functions, with regard to IT- Software Services or IT Enabled Services (herein after referred to as 'such Services'), including particularly conceptualization and design for scope of such Services, is driven by the foreign principal. The Eligible Enterprise in India would largely be involved in the actual development, implementation or maintenance of specific features or portions of the IT Services / IT Enabled Services, with limited inputs on design as necessary, within the strategic direction / framework provided by the foreign principal.

- The principal provides funds/capital for such Services. The principal bears the risk of failure of the outcome of such Services and will be the owner of the outcome of such Services and also any intangible generated in rendering such Services, while the Eligible Enterprise is allocated a guaranteed remuneration on services pertaining to Eligible International Transactions, irrespective of whether the outcome of such Services is a success or a failure.

- The Eligible Enterprise is required to report back to the principal on a regular basis, *e.g.* at predetermined milestones. The principal is expected to be able to assess the outcome of the Service activities. Any suggestion to the modification of the scope of such Services by the Eligible Enterprise is subject to the review and approval by the foreign principal who makes the relevant decisions to control the risks.

- The Eligible Enterprise, in respect of services pertaining to Eligible International Transactions, does not assume risks or has insignificant realised risk such as market risk, business risks, economic conditions risk, credit & collection risk, capacity utilisation risk, quality risk product / service acceptance risk, product development risk, infrastructure utilisation risk, intellectual property infringement risk.

- The entirety of the product life cycle and / or software development life cycle is not undertaken by the Eligible Enterprise.

- The Eligible Enterprise, as contract service provider, has no right to ownership on the outcome of any intangible generated or arising during the course of rendering such Services. The rights in the developments contractually vest since inception with the foreign principal and the registration of any IP arising from such development is made by the foreign principal. Involvement of the Indian personnel to comply with filing requirements, without any underlying rights in the exploitation by the Indian personnel and / or by the Eligible Enterprise, is evident from the employee contract and / or contract between Eligible Enterprise and its foreign principal.

- The patent registration, if any, cannot be commercially exploited on a standalone basis because its contribution to the overall value chain is insignificant.

- The terms and conditions regarding ownership of intangibles would have been similar if the activities carried on by the Eligible Enterprise were or could have been outsourced to a third party.

3.5.4 The Committee has taken note of all representations, including the ones from CII and NASSCOM as well as data submitted by various other stakeholders. The Committee finds that as per illustrative data provided by NASSCOM, the margin of captive development centre in case of one company has been accepted in China at 14% while for the same company it is 10% in Canada. In the case of another company, the margin in the ITES segment has been accepted at 10% in Philippines.

3.5.5 Many MNCs are presently carrying out activities such as product development, analytical work, software development, etc. in India. This is a

highly competitive field and India does not have a monopoly. Hence, there is need for clarity on their taxation. As per the PMO's Press release "Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer".

3.5.6 The Committee analysed in detail, the data of the assessees engaged in IT - Software sector, available with the Department. The Committee notes that there has been an upward movement in net margins as disclosed by taxpayers for the assessment years 2006-07 to 2008-09. The average rate of margins disclosed by the assessees for the assessment year 2008-09, audit for which was completed in financial year 2011-12 and for which data is available, is around 15% whereas, the TPOs have benchmarked it around 24% before giving the benefit of the margin variation under section 92C. However, the margins adopted by the TPOs have been challenged in a large number of cases. Considering that the Committee is recommending adoption of Safe Harbour provisions from assessment year 2013-14 and taking note of the developments happening in this sector, **the Committee recommends a rate of 20% for adoption as the Safe Harbour operating margin for the first two years.** This is a 33% increase over the average margin of 15% disclosed in assessment year 2008-09 and takes into account the average rates of margins adopted by the Department.

3.5.7 In respect of ITES sector, the Committee notes that the Confederation of Indian Industry (CII) has classified the ITES segment on the basis of turnover for the purposes of providing Safe Harbour. The classification is as follows:

Large Companies - Turnover > Rs. 2000 crore

Medium Companies - Turnover > Rs.250 crore < Rs.2000 crore

Small Companies - Turnover < Rs.250 crore

3.5.8 The Committee also finds that in this sector also there has been an upward movement in net margins as disclosed by taxpayers for the assessment years 2006-07 to 2008-09. Besides, the margins are higher for the bigger entities having value of international transactions in excess of Rs. 500 crore. The average rate of margins disclosed by the assesses for the assessment year 2008-09, audit for which was completed in financial year 2011-12 and for which data is available, is around 15% for companies having value of international transactions up to Rs. 500 crore and 18% for enterprises having value of international transactions above Rs. 500 crore. The TPOs have benchmarked the segment at around 26% before giving the benefit of margin variation under section 92C. However, the margins adopted by the TPOs have been challenged in a large number of cases. Considering that the Committee is recommending adoption of Safe Harbour provisions from assessment year 2013-14 and taking note of the developments happening in this sector, **the Committee recommends a rate of 20% for adoption as the Safe Harbour operating margin for the first two years in respect of enterprises having value of international transactions up to Rs. 500 crore and a operating margin rate of 22% for enterprises having value of international transactions above Rs. 500 crore in this sector/segment.**

3.5.9 Committee also took note of a situation where the location of business in India ensures certain in-built advantages which would make the working of these units more competitive in the universal market. The adoption of a higher per cent of profits than that disclosed by the taxpayers as Safe Harbour takes into account such locational savings and advantages as also market premiums .Since no such explicit adjustments have been done by the department in the last three years to specifically factor in locational savings and advantages and market premium, **the Committee has made no such adjustments while recommending margins for the first two years of the Safe Harbour regime.**

3.5.10 The Committee understands that for computing the above-recommended margins, the method of computing the Profit Level Indicator (PLI) is of critical importance. Operating Profit Margin is the most crucial aspect for calculating the PLI. **Accordingly, the Committee recommends that operating cost, operating revenue and operating profit for the purposes of calculating PLI should be defined as follows**:

- "Operating profit is the profit earned from normal operations of the Eligible Enterprise. It is computed as the operating revenues of the Eligible Enterprise less the operating expenses incurred for an accounting period."
- "Operating Expenses are the costs of the Eligible Enterprise incurred during the course of its normal operations and in connection with Eligible International Transactions for the previous year, including depreciation / amortization expenses relating to assets used by the Eligible Enterprise but excluding interest expense, provisions for unascertained liabilities, pre-operative expenses, the loss arising out of translations of foreign currency items, extraordinary and other items not relating to the operating activities of the Eligible Enterprise for the previous year, the loss on sale of assets / investments of the company, and the effects relating to the income tax expense of the company"
- "Operating Revenues are the revenues of the Eligible Enterprise earned in connection with Eligible International Transactions and during the course of its normal operations for the previous year, but excluding interest income, the income arising out of translations of foreign currency items, the income on sale of assets investments of the company, the refunds relating to the income tax expense of the company, provisions no longer required written back and extraordinary and other items not relating to the operating activities of the Eligible Enterprise for the previous year."

3.5.11 Accounting terms used in these Rules shall be defined in accordance with generally accepted financial accounting principles in India.

3.5.12 **The Committee recommends that once Safe Harbour rules are opted for by a taxpayer, no margin variation benefit under section 92C or any other comparability adjustment such as, capacity, risk, working capital, etc. would be permitted**.

3.5.13 To reduce compliance costs for the taxpayers, it is imperative that the documentation burden on the taxpayers opting for Safe Harbour is made less stringent, as compared to an assessee choosing regular TP documentation and scrutiny by the Department. Accordingly, the **Committee recommends that such an enterprise need not maintain information and documents specified in clauses (g) to (m) of Rule 10D(1) in respect of the Eligible International Transactions**.

3.5.14 The Committee clarifies that Safe Harbour rules would not give immunity from scrutiny of any international transactions other than the Eligible International Transactions that have been opted by the Eligible Enterprise to be covered under Safe Harbour.

3.6 Recommendations on Procedural /Administrative Issues

3.6.1 An Eligible Enterprise may exercise its option for accepting the Safe Harbour for the year by filing an option form with the Assessing Officer not later than the due date for filing the Income-tax return. If necessary a new Statutory Form for exercising Safe Harbour option to be filed along with return of income may be prescribed. Alternately, the 3CEB Report should be modified to provide for indication of election of Safe Harbour option for the year along with identification of Eligible International Transactions.

3.6.2 The Committee recommends that the AO must compulsorily refer such cases to the TPO who will conduct the functional analysis to determine the Eligible Enterprise as well as the Eligible International Transaction before accepting the results of the taxpayer under Safe Harbour. Besides, there should be strict penalties if any of the eligible conditions laid down for Safe Harbour are violated by the taxpayer.

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Annexure I

PM sets up committee to review Taxation of Development Centres and the IT Sector, Safe Harbour Provisions to be Finalised soon

July 30, 2012
New Delhi

The Prime Minister has constituted a Committee to Review Taxation of Development Centres and the IT Sector. The Committee will engage in consultations with stakeholders and related government departments to **finalise the Safe Harbour provisions** announced in Budget 2010 sector-by-sector. It will also suggest the approach to **taxation of Development Centres.**

2. The Prime Minister had earlier set up an Expert Committee on GAAR under the Chairmanship of Dr. Partho Shome to engage in a widespread consultation process and finalise the GAAR Guidelines. The response has been overwhelmingly positive.

3. While this committee would address concerns on GAAR provisions and would reassure investors about the predictability and fairness of our tax regime, it was felt that there is still a need to address some other issues relating to the taxation of the IT Sector such as the approach to taxation of Development Centres, tax treatment of "onsite services" of domestic software firms, and also the issue of finalising the Safe Harbour provisions announced in Budget 2010.

4. Many MNCs carry out activities such as product development, analytical work, software development, etc. through captive entities in India. They exist in a wide range of fields including IT software, IT hardware, Pharmaceutical R&D, other automobile R&D and scientific R&D. These are popularly called **Development Centres**. Over 750 MNCs have such centres at over 1100 locations in India. The reason for this large concentration of Development Centres in India is the worldwide recognition of India as a place for cost competitive, high quality knowledge related work. Such Development Centres provide high quality jobs to our scientists, and indeed make India a global hub for such Knowledge Centres. However, India does not have a monopoly on Development Centres. This is a highly competitive field with other countries wanting to grab a share of the pie. There is need for clarity on their taxation.

5. As far as **Safe Harbour provisions** are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application.

Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer.

6. The resolution of the above tax issues requires a comprehensive approach in which other government departments are consulted and industry bodies are taken on board. The overall goal is to have a fair tax system in line with best international practice which will promote India's software industry and promote India as a destination for investment and for establishment of Development Centres. Therefore, the Prime Minister has constituted a Committee consisting of experts from the Income Tax Department, both serving and retired, who will examine the issues in detail and submit proposals in a short time. An arm's length exercise of this nature will allay a lot of concerns in addition to the immediate resolution of issues that is necessary.

7. For this purpose, a **Committee on Taxation of Development Centres and the IT sector** has been constituted consisting of:

1) Shri N. Rangachary, former Chairman CBDT & IRDA - Chairman

2) Ms Anita Kapur, Director General (IT) - Member

3) Ms Rashmi Sahani Saxena, DIT (TP) - Member

4) Any other officer from the Income Tax Department to be co-opted by the Chairman

8. The **Terms of Reference of the Committee** will be to:

i) Engage in consultations with stakeholders and related government departments to finalise the approach to Taxation of Development Centres and suggest any circulars that need to be issued.

ii) Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector. The Committee will also suggest any necessary circulars that may need to be issued.

iii) Examine issues relating to taxation of the IT sector and suggest any clarifications that may be required.

9. The Committee will work to the following time schedule:

i) Finalise the approach to taxation of Development Centres and suggest any necessary clarifications by **31 August 2012.**

ii) Suggest any necessary clarifications that may be needed to remove ambiguity and improve clarity on taxation of the IT Sector by **31 August 2012.**

iii) Finalise Safe Harbour Rules individually sector-by-sector in a staggered manner and submitting draft Safe Harbour provisions for three sectors/sub-activities each month beginning with the first set of suggestions **by 30 September 2012.** All Safe Harbour provisions can be finalised by **31 December 2012.**

10. The Department of Revenue will provide all necessary support to the Committee to facilitate its work including office assistance and assistance to facilitate consultations.

Annexure II

F.No.A. 50050/103/2012-Ad.I
Government of India
Ministry of Finance
Department of Revenue
***

New Delhi, dated the 13th September, 2012.

OFFICE MEMORANDUM

Subject: Constitution of a Committee to Review Taxation of Development Centres and the IT Sector- Reg.

***

The undersigned is directed to refer to Department of Revenue's O.M. of even number dated 3rd August, 2012 on the above cited subject and to say that considering the paucity of adequate data required to draft the rules, the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors/activities:

(i) IT Sector
(ii) ITES Sector
(iii) Contract R&D in the IT and Pharmaceuticals Sector
(iv) Financial Transactions – Outbound loans
(v) Financial Transactions – Corporate Guarantee
(vi) Auto Ancillaries – Original Equipment Manufacturers

2. In view of the above, the revised timelines for submitting the reports on Safe Harbour provisions by the Committee have been modified as under:

First Report by 15.10.2012;
Second Report by 15.11.2012; and
Final Report by 31.12.2012.

(M.L. Meena)
Joint Secretary to the Government of India

Copy to:

1. Shri N. Rangachary, Chairman of the Committee to Review Taxation of Development Centres and IT Sector. His kind attention is invited to Notes dated 12/09/2012.
2. Ms. Anita Kapur, Director General(IT), Member of the Committee.
3. Ms. Rashmi Saxena Sahni, DIT(TP), Member of the Committee.
4. Shri Dinesh Kanabar, Tax Expert, Member of the Committee.
5. Shri B.V.R. Subrahmanyam, Joint Secretary to PM.
6. PS to FM.
7. PPS to Secretary(Revenue).
8. Chairman, CBDT.

CONFIDENTIAL

Third Report of the Committee to Review Taxation of Development Centres and the IT Sector

(Safe Harbour for Outbound Loans and Corporate Guarantees)

18th December, 2012

FOREWORD

The Committee set-up by the Government to examine some of the issues relating to taxation of income of persons engaged in the IT sector is glad to furnish its third report and the second on Safe Harbour provisions. The first report, submitted on 14th September, 2012, had addressed the taxation issues confronting the IT Sector and the Development Centres. The second report (first on Safe Harbour provisions), submitted on 13th October, 2012, had laid down the recommendations for Safe Harbour provisions for the IT-Software and ITES sectors.

This report contains the Committee's recommendations for Safe Harbour provisions in respect of two areas of the financial sector, i.e., Outbound Loans and Corporate Guarantees. A final report on Safe Harbour provisions for two more sectors would be submitted by the Committee in December, 2012.

While furnishing this report, I must duly acknowledge the stellar role played by its members, namely, Ms. Anita Kapur, Member (A&J), CBDT, Ms. Rashmi Saxena Sahni, DIT (Transfer Pricing-I), Delhi and Mr. Dinesh Kanabar, Tax Expert in analyzing the various data and showing a rare commitment and devotion. Their technical and intellectual inputs have enabled the Committee to finalise its recommendations.

I must also acknowledge the important role played by the three senior officers of the Department, namely Shri Subhakant Sahu, Shri D. Prabhakar Reddy and Shri Sobhan Kar, Addl. Commissioners of Income-tax, in assisting the Committee in its deliberations and providing inputs on relevant issues.

I would also like to place on record the Committee's appreciation of the efforts put in by the staff of the DIT (Transfer Pricing-I), Delhi, especially Shri Sumit Banerjee, ITI, in providing logistical assistance to the Committee in discharging its responsibilities

N. Rangachary,
Chairman
18th December, 2012

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Third Report of the
Committee to Review Taxation of Development
Centres and the IT Sector

(Safe Harbour for Outbound Loans and Corporate Guarantees)

Submitted by

Anita Kapur	Rashmi Saxena Sahni	Dinesh Kanabar
Member (A&J), CBDT	DIT (TP-I), Delhi	Tax Expert
Member	Member	Member

N.Rangachary
Former Chairman, CBDT & IRDA,
Chairman

PART-1: INTRODUCTION

1.1 Prime Minister's Office issued a press release on July 30, 2012 **(Annexure - I),** stating that the Hon'ble Prime Minister had constituted a Committee to Review Taxation of Development Centres and the IT Sector under the Chairmanship of Shri N. Rangachary, former Chairman CBDT & IRDA. The Committee submitted its first Report to the Government on 14th September, 2012 covering issues listed in the terms of reference of the Committee, except the following:

"Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector."

1.2 The rationale for entrusting the Committee with the task of finalising Safe Harbour rules was explained in the Press Release (ibid) as follows:

"As far as Safe Harbour provisions are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the assessee"

1.3 The Committee was advised to suggest Safe Harbour Rules individually sector-by-sector in a staggered manner and submit draft Safe Harbour provisions for three sectors/sub-activities each month beginning with the first set of suggestions by 30th September 2012 and finalise all Safe Harbour provisions by 31st December 2012.

1.4 Vide Office Memorandum dated 13th September, 2012 (**Annexure-II**), the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors / activities:

(a) IT Sector

(b) ITES Sector

(c) Contract R&D in the IT and Pharmaceutical Sector

(d) Financial Transactions – Outbound loans

(e) Financial Transactions – Corporate Guarantee

(f) Auto Ancillaries – Original Equipment Manufacturers

1.5 The timelines for submission of recommendations of the Committee on Safe Harbours were also revised as follows vide the aforesaid OM:

- First Report by 15-10-2012
- Second Report by 15-11-2012
- Third Report by 31-12-2012

However extension of time for submission of this report by 26th November, 2012 and thereafter till 15th December, 2012 ,was sought by the Chairman of the Committee from the Hon'ble Finance Minister vide letters dated 9th and 26th November, 2012 respectively. Accordingly, the report is being submitted now.

1.6 The Committee submitted its second report, the first on Safe Harbours, on 13th October, 2012 to the Government. That report contained its recommendations for Safe Harbour rules for IT and ITES sectors. In the meantime, Ms. Anita Kapur, Member of the Committee, was elevated as Member, CBDT. The Department of Revenue, vide OM dated 16th October 2012, (**Annexure-III**) has clarified that Ms. Anita Kapur will continue to be a Member of the Committee.

1.7 This report, the Committee's third, makes recommendations for Safe Harbour rules for financial transactions of outbound loans and corporate guarantees.

***

PART-2: DELIBERATIONS IN THE COMMITTEE

2.1 Part 2 of the previous report of the Committee on Safe Harbours for the IT (Software) & ITES sectors gave a detailed analysis of the statutory provisions regarding Safe Harbours [Section 92CB of the Income-tax Act]; the need for having Safe Harbours and the opposition to the same; types of Safe Harbours; cross country transfer pricing simplification measures; and existing transfer pricing simplification measures in India.

Those concerns, analysis and explanations, in the view of the Committee, are also relevant for this report. However, no detailed discussion on these issues is being incorporated here to avoid repetition.

2.2 Suggestions and data to frame Safe Harbour provisions for outbound loans and corporate guarantees were invited from the following stakeholders:

- Central Board of Direct Taxes
- NASSCOM (National Association of Software and Service Companies)
- CII (Confederation of Indian Industry)
- FICCI (Federation of Indian Chambers of Commerce and Industry)
- ASSOCHAM (Associated Chambers of Commerce and Industry of India)
- PHDCCI (PHD Chamber of Commerce & Industry)
- ICAI (Institute of Chartered Accountants of India)
- PWC (Price Waterhouse Coopers)
- E&Y (Ernst & Young)
- Deloitte Haskins & Sells
- KPMG
- BMR Advisors
- Vaish & Associates, Delhi
- T. P. Ostwal & Associates, Mumbai

2.2.1 The Income Tax Department **(Annexure-IV)** was requested to provide data along with comments of CBDT, if any, for the consideration of the Committee. Earlier also details for Assessment Years 2006-07, 2007-08 and 2008-09 in regard to these two segments had been called for along with data for all the segments to be covered by Safe Harbour. Details relate to the value of international transactions entered into by the assessee and the bench marking, if any, done by the Transfer Pricing Officers (TPOs). The industry stakeholders were also asked for their views as well as data. For this report, data has been received only from CBDT and some of the stakeholders have filed written submissions expressing their views.

2.2.2 Discussion was also held by a Committee member, accompanied by an officer deputed to assist the Committee, with the officers from RBI at Mumbai on 5.11.2012, to understand the Policy perspectives governing outflow of funds for Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) abroad including loans and corporate guarantees (outbound) and limitations on foreign remittances etc. as well as policy guidelines for risk management relating to Foreign Exchange (Forex) transactions in banks. These issues were discussed with the following officers of RBI:

i. Advisor-in-Charge, and Other Officers of Monetary Policy Department

ii. Chief General Manager-in-Charge and Other Officers of Foreign Exchange Department

2.2.3 In addition to the above discussion, the Committee also took note of the data/instructions available on RBI website. Committee acknowledges the usefulness of the OECD discussion paper on Safe Harbours and Multi-country Analyses that were considered in the earlier Report. The Practical Manual on Transfer Pricing for Developing Countries, as approved by United Nation's Committee of Experts on International Cooperation in Tax Matters in its meeting held at Geneva from 15-19 October, 2012 was also considered. Data obtained/ received from some of the stake holders as well as their views and present

prevalent conditions in the Indian economy and the bench marking practices being followed by the Transfer Pricing Officers also have been considered while adopting the flexi policy design for these Safe Harbour recommendations.

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PART-3: SETTING THE CONTEXT

3.1 Background

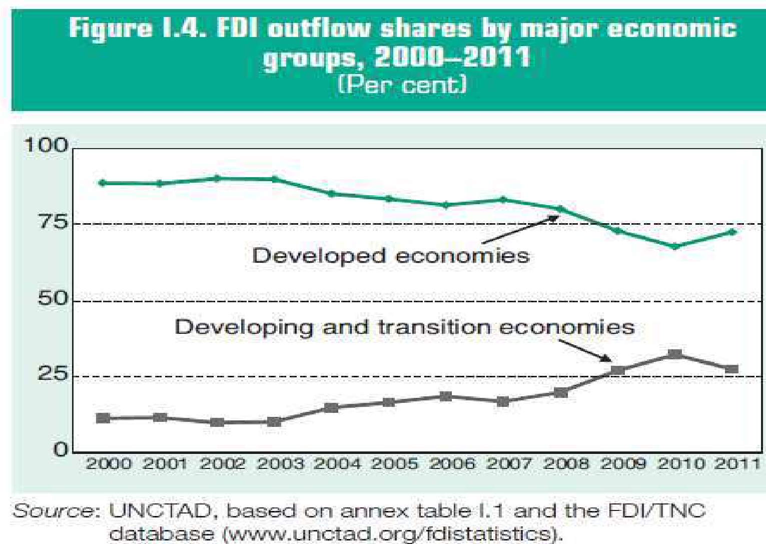
3.1.1 Before designing India specific Safe Harbour for these two sectors, it is imperative to analyse both global and domestic trends in these sectors. Emerging Market Economies (EMEs), including India, are increasingly becoming a destination for foreign investment. But more importantly, a growing counter trend is also visible in EMEs, where a number of private as well as state-owned enterprises are increasingly undertaking outward expansion of their business operations through foreign direct investments (FDI) with a view to acquiring a regional or global reach.

3.1.2 According to UNCTAD's World Investment Report 2011[1], the stock of outward FDI from developing economies reached US$ 3.1 trillion in 2010 (15.3 per cent of global outward FDI stock), up from US$ 857 billion (10.8 per cent of global outward FDI stock) 10 years ago.

3.1.3 UNCTAD's World Investment Report 2012 [2], indicates that even though outward FDI from developing economies declined by 4 per cent in 2011, their share in global outflows still remained high at 23 per cent. Flows from Latin America and the Caribbean fell 17 per cent, largely due to the repatriation of capital to the region (counted as negative outflows) motivated in part by financial considerations (exchange rates, interest rate differentials).

[1] UNCTAD's World Investment Report 2011 - http://unctad.org/en/docs/wir2011_embargoed_en.pdf

[2] UNCTAD's World Investment Report 2012 - http://unctad.org/en/PublicationsLibrary/wir2012_embargoed_en.pdf



Source: UNCTAD, based on annex table I.1 and the FDI/TNC database (www.unctad.org/fdistatistics).

3.2 Types of intra-group cross border financial transactions

Intra-group cross border financial transactions can be of the following types or their variants with complicated holding structures:

- Equity either through ordinary or preferential shares
- Debt, including short term and long term loans. It may also take the form of debentures - non-convertible or fully or partially convertible.
- Business advances
- Extending credit facilities in the form of delaying the receivables or payables, as the case may be
- Guarantees

3.3 Indian investments abroad

3.3.1 According to the Annual Report of Reserve Bank of India (RBI) for the financial year 2011-12, the stock of outward FDI (including equity and debt) from India had reached US$ 112 billion (cumulative) by the end of the year. Net outward FDI flows (on Balance of Payments [BoP] basis), recorded a sharp uptrend at US$ 74.3 billion during F.Y 2005-06 to 2009-10 as compared to US$ 8.2 billion in the period F.Y 2000-01 to 2004-05. F.Y 2009 -10 did, however, see some fall.

3.3.2 In recent years, outward FDI continues to be mainly financed through equity and loans. However, the number of guarantees issued has been rising since F.Y 2010-11.and amounted to US$ 27 billion or Rs. 1,21,000 crores in F.Y 2010-11. Increasing use of inter-corporate Guarantees by Indian MNCs to tide over tight liquidity position in India is also due to the fact that RBI has further liberalized the process of issuance of corporate guarantees to foreign subsidiaries, aimed at helping companies boost investment in overseas units thereby giving them greater "operational flexibility" to expand their global footprint.

3.3.3 The data in Table 1 gives year-wise details of outward FDI (Equity and loans) and Guarantees issued by Indian entities to or on behalf of their JVs / WOS abroad.

Table 1: Year–wise position of actual outflows in respect of outward FDI & guarantees issued

(in million US Dollar)

Period	Equity	Loan	Guarantee Invoked	Total	Guarantee Issued
2000-2001	602.12	70.58	4.97	677.67	112.55
2001-2002	878.83	120.82	0.42	1000.07	155.86
2002-2003	1746.28	102.10	0.00	1848.38	139.63
2003-2004	1250.01	316.57	0.00	1566.58	440.53
2004-2005	1481.97	513.19	0.00	1995.16	315.96
2005-2006	6657.82	1195.33	3.34	7856.49	546.78
2006-2007	12062.92	1246.98	0.00	13309.90	2260.96
2007-2008	15431.51	3074.97	0.00	18506.48	6553.47
2008-2009	12477.14	6101.56	0.00	18578.70	3322.45
2009-2010	9392.98	4296.91	24.18	13714.07	7603.04
2010-2011	9234.58	7556.30	52.49	16843.37	27059.02
2011-12*	4031.45	4830.01	0.00	8861.46	14993.80
Total	**75247.61**	**29425.32**	**85.40**	**104758.30**	**63504.05**

* April 2011 to February 22, 2012

Source: RBI Website

** Out of total amount of US$ 63504.05 milion being Guarantees issued an amount of US$ 85.40 million has been remitted due to the invocation of the guarantee.*

3.3.4 Table 2 below summarises the sectoral outward flow of FDI (Equity and loans).

Table-2: Major sector-wise overseas investments by Indian companies

(amounts in billion US Dollar)

Period	2008-09	2009-10	2010-11	2011-12*	Total
Manufacturing	10.18	5.35	5.04	2.74	**23.31**
Financial Insurance, Real Estate Business & Business Services	3.55	4.41	6.53	2.53	**17.03**
Wholesale & Retail Trade, Restaurants & Hotels	1.17	1.13	1.89	1.00	**5.19**
Agriculture & allied activities	2.38	0.95	1.21	0.41	**4.94**
Transport, Communication & Storage Services	0.31	0.38	0.82	1.34	**2.85**
Construction	0.35	0.36	0.38	0.37	**1.46**
Community, Social & Personal Services	0.39	0.18	0.70	0.18	**1.45**
Electricity, Gas & Water	0.14	0.84	0.10	0.04	**1.19**
Miscellaneous	0.12	0.11	0.18	0.10	**0.51**
Total	**18.58**	**13.71**	**16.84**	**8.73**	**57.86**

* April 2011 to February 22, 2012

(Source: RBI Website)

3.3.5 The top 10 country-wise overseas investment by Indian companies is shown below in Table 3.

Table 3: Top ten country-wise overseas investments by Indian companies

(amount in billions US Dollar)

Country	2008-09	2009-10	2010-11	2011-12*	Total
Singapore	4.06	4.20	3.99	1.86	**14.11**
Mauritius	2.08	2.15	5.08	2.27	**11.57**
Netherlands	2.79	1.53	1.52	0.70	**6.54**
United States of America	1.02	0.87	1.21	0.87	**3.97**
United Arab Emirates	0.63	0.64	0.86	0.38	**2.51**
British Virgin Islands	0.00	0.75	0.28	0.52	**1.55**
United Kingdom	0.35	0.34	0.40	0.44	**1.53**

Cayman Islands	0.00	0.04	0.44	0.14	**0.62**
Hong Kong	0.00	0.00	0.16	0.31	**0.46**
Switzerland	0.00	0.00	0.25	0.16	**0.41**
Other countries	7.65	3.19	2.65	1.23	**14.71**
Total	**18.58**	**13.71**	**16.84**	**8.86**	
*April 2011 to February 28, 2012					

(Source: RBI Website)

3.4 Liberalization of Outward Investment Regulations in India under RBI

3.4.1 The broad approach has been to facilitate outward foreign direct investment through joint ventures and wholly owned subsidiaries including SPVs to promote exports, investments, cross border acquisitions as well as to provide access to cheaper overseas funds.

3.4.2 The per annum upper limit for automatic approval was raised In 2002, to US$100 million. This upper limit was, however, discontinued in March 2003 when the automatic route for outward FDI was further liberalised to enable Indian businesses to invest to the extent of 100 % of their net worth. Since then the limit of outward FDI has been gradually increased and today it is 400% of their net worth. [3]

3.4.3 For the purpose of determining the 'total financial commitment' within the limit of 400% as specified above, the following shall be considered, namely:

a. 100% of the amount of equity shares;
b. 100% of the amount of compulsorily and mandatorily convertible preference shares;
c. 100% of the amount of other preference shares;
d. 100% of the amount of loan;

[3] RBI's Master Circular on Direct Investment by Residents in JV / WOS Abroad dated July 02, 2012

e. 100% of the amount of guarantee (other than performance guarantee) issued by the Indian party;

3.4.4 The present ceiling of 400% of net worth, however, is not applicable for the following:

- Investments made out of balances held in the Exchange Earners' Foreign Currency (EEFC) account of the Indian party or out of funds raised abroad through ADRs/GDRs.
- Indian companies engaged in the energy and natural resources sectors, such as, oil, gas, coal and mineral ores, though they would require prior approval of the Reserve Bank of India.

3.4.5 Current RBI regulations [3] do not permit an Indian party to make overseas direct investment in certain real estate activities {*i.e*., buying and selling of real estate or trading in Transferable Development Rights (TDRs)} and banking business. For undertaking activities in the financial services sector, certain conditions as specified by the Reserve Bank of India need to be adhered to.

3.4.6 Thus, all the outward FDI and also financial commitments would be intra-group capital financial transactions within the meaning of 'international transactions' as provided in Section 92B of the Income-tax Act.

3.4.7 The Committee also perused the Master Circular titled "Direct Investment by Residents in JV/WOS abroad" dated July 02, 2012 of Reserve Bank of India, which is a compendium of all notifications/circulars incorporating the developments, till that date. The Master Circular (ibid) permits Indian residents to make investment in overseas joint ventures and wholly owned subsidiaries either under the automatic route or the approval route. Under automatic route, all proposals are routed through designated authorized dealer banks and the Indian Party does not require any prior approval from the Reserve Bank of India (RBI) for setting up a JV/WOS abroad. Proposals not covered by the conditions

listed under the automatic route require the prior clearance of the RBI and come under the approval route.

3.4.8 RBI's Master Circular of July 2nd 2012 also refers to Notification dated July 7, 2004 [4] on Foreign Exchange Management (Transfer or Issue of Any Foreign Security) (Amendment) Regulations, 2004**,** wherein various terms relevant in the context of outward FDI are defined as under.

- '**Direct investment outside India**' means investment by way of contribution to the capital or subscription to the Memorandum of Association of a foreign entity or by way of purchase of existing shares of a foreign entity either by market purchase or private placement or through stock exchange, but does not include portfolio investment;
- '**Financial commitment**' means the amount of direct investment by way of contribution to equity and loan and 100% of the amount of guarantees issued by an Indian party to or on behalf of its overseas Joint Venture Company or Wholly Owned Subsidiary;
- '**Joint Venture (JV)**' means a foreign entity formed, registered or incorporated in accordance with the laws and regulations of the host country in which the Indian party makes a direct investment; and
- **'Wholly Owned Subsidiary (WOS)**' means a foreign entity formed, registered or incorporated in accordance with the laws and regulations of the host country, whose entire capital is held by the Indian party**.**

3.5 Under Section 186(2) of the proposed Companies Bill, 2011, there is a limitation for loans. The section states that no company shall directly or indirectly give any loan to any person or other body corporate exceeding 60% of its paid-

[4] RBI's Notification No. FEMA 120/ RB-2004 dated: July 7, 2004

up share capital, free reserves and securities premium account or one hundred % of its free reserves and securities premium account, whichever is more.

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PART-4: FINANCIAL TRANSACTIONS-OUTBOUND LOANS

4.1 Explanation inserted by the Finance Act, 2012 to Section 92B of Income Tax Act (with retrospective effect from 01-04-2002) provides inclusive definition of the expression international transaction. Explanation (i) (c) to Sub section 2 states, "*capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business will be an international transaction*". As per Section 92B of the Act, all outbound loans between associated enterprises are international transactions. They fall in the category of financial commitments as defined by RBI.

4.2 Today intra-group capital financing constitutes one of the major cross-border transactions between related entities, and is thus covered by Indian transfer pricing regime. The outflow of money in the form of loans has increased in magnitude and so has the complexity of issues relating to benchmarking of interest on outbound loans. The key reasons for this complexity are inherent subjectivity, the quantum of these transactions and the requirement of intensive analysis of facts. This is coupled with the need to understand complexities of inter-relationship between the loans and interest rates from lenders' perspective, the risks associated with the loan transactions and also credit ratings of the associated enterprises. Thus estimating arm's length price for an intra-group financial transaction is complicated both for the tax administration and the assessee.

4.3 International practice

4.3.1 The Committee also took note of Safe Harbour interest rates on loans and also simplification measures to deal with the issue of benchmarking interest on intra-group loans provided in some of the countries, which are summarized in the Table below (Source: OECD's Multi-Country Analysis of Existing Transfer

Pricing Simplification Measures – 2012 Update; website of Revenue Authorities of Respective Countries).

Table 4

A: Safe Harbour interest rates on loans

Sl. No.	Name of the Country	Nature of Loans Covered	Exceptions	Safe Harbour Interest Rates	Definitions
1	USA	Loans denominated in US Dollars	Not available to assessee in the business of making loans or for loans expressed in a Currency other than USD.	100% to 130% of Applicable Federal Rate (AFR)	Applicable Federal Rate (AFR) is the Rate published monthly by the IRS for federal income tax purposes. Every month, the IRS publishes these rates in accordance with section 1274(d) of the Internal Revenue Code. AFR is based on the average interest rate on Federal Government debt with similar maturity dates.
2	Slovenia			Interest is in line with the "tax-recognised interest rate" published by the Ministry of Finance prior to the beginning of the tax period to which it applies	"Tax-recognised interest rate" is the interest rate published by the Ministry of Finance prior to the beginning of the tax period to which it applies
3	South Africa	Inbound loans	Outbound loans	The interest payment of Prime Plus 2% for South African Rand (ZAR) denominated loans and LIBOR plus 2% for foreign denominated loans are allowed.	**Prime Rate** is the Prime Rate of Interest published by South African Reserve Bank. Currently the prime interest rate is at 8.5%.

B: Simplification measures for loan transactions

Sl. No.	Name of the Country	Nature of Loans Covered	Exceptions	Nature of Simplification Measures	Definitions
1	Japan	Lending or borrowing, where internal or external comparables cannot be found	Financial Institutions	The interest rate at which foreign affiliate would have borrowed from a non affiliated bank under similar conditions in terms of currency, borrowing date and borrowing period or the interest rate that would normally be earned on the funds involved in the foreign affiliated transaction, assuming that they were invested in Government Securities or the likes under similar conditions in terms of currency, transaction date and transaction period.	
2	New Zealand	Low value loans with principal less than NZ$2 million.		300 basis points over relevant base indicator is considered to be broadly indicative of Arm's Length rate, in the absence of a readily available market rate for a debt instrument with a similar terms and risk characteristics.	Benchmarking BBB rated loans (which is the credit rating for most of international groups operating in New Zealand) is an accepted base indicator.

4.3.2 Briefly stated, in the US, the Safe Harbour is based on the Applicable Federal Rate, which is notified every month and which is linked with Federal Government debt with similar maturity dates, i.e., the domestic rate is taken as a benchmark. The approach of this Committee in having a flexi policy design is also on similar lines and is based on the relevance of domestic interest rate for outbound loans sourced from Indian Rupees, which is discussed hereinafter.

4.4 Need for Safe Harbour in India on outbound loans

4.4.1 In view of the Committee, since the quantum of outbound intra-group loans and complexity of dealing with the transfer pricing issue of benchmarking interest on outbound intra-group loan transactions has been increasing, a commonality of approach and certainty by way of Safe Harbours in benchmarking would, to an extent, bring in clarity and transparency in their benchmarking and reduction in protracted litigation. Analysis of Departmental data (**Annexure-V**) shows that the dispute is primarily on interest chargeable for outbound loan and not so much on interest chargeable on inbound loans.

4.4.2 In most cases of inbound intra-group loan transactions, the interest rates, which are linked with LIBOR (London Inter-Bank Offer Rate) have been accepted by the TPOs. Further, the RBI also regulates the interest rates on inbound loans or External Commercial Borrowings, by capping or providing upper ceiling on interest rates, which is also linked with 6-month LIBOR rates. There is no conflict between practice and regulations either with regard to linking in-bound intra-group loans with LIBOR.

4.4.3 The main and significant dispute between the assessees and the Department being with regard to benchmarking of outbound intra-group loans, there is a need for Safe Harbours for interest rates on outbound loans only. This is the mandate given to this Committee vide Office Memorandum dated 13th September 2012 (**Annexure-II**).

4.5 Analysis of Regulations for Inter-Corporate Loans (both In-bound and Out-bound) under RBI and Companies Act.

4.5.1 In order to understand the issue, the Committee analysed the prevalent definition of loan and domestic regulations governing it. As per RBI, loans are direct lending of funds by a creditor to a debtor through arrangements. These include, loans to finance trade (i.e. Buyers' credit in which a bank or a financial institution or an export credit agency in the exporting country extends a loan directly to a foreign buyer or to a bank in the importing country to pay for the purchase of goods and services), mortgages, and other loans and advances. Financial leases and repurchase agreements are also considered as loans.

4.5.2 RBI does not regulate the interest rate chargeable on the outbound loans, but loans received from the non-resident direct investor as well as loan extended to the subsidiaries/associates abroad has to be reported in a prescribed form.

4.5.3 Section 295 of the Companies Act, 1956, deals with inter-corporate loans. It also does not have any prescription on limit for the interest chargeable for such loans. Further,

- Under Section 186(2) of the Companies Bill, 2011, no company shall directly or indirectly give any loan to any person or other body corporate exceeding 60% of its paid-up share capital, free reserves and securities premium account or one hundred per cent of its free reserves and securities premium account, whichever is more.
- Under Section 186(7) of the proposed Companies Bill, 2011, no company shall directly or indirectly give any loan to any person or other body corporate at a rate of interest lower than the prevailing rate of interest on dated Government Securities. Dated Government Securities are those Government Securities, which have a maturity of more than one year.

4.5.4 Thus, if the proposed Companies Bill becomes an Act, then interest on any inter-corporate loans shall not be less than the prevailing interest on Government Securities of same or similar maturity.

4.6 Issues considered by the Committee

4.6.1 Concerns raised by stakeholders

In response to the request of the Committee, one of the stakeholders raised a concern that Safe Harbours for loans are not appropriate for the following reasons:

- Interest rate on loan is a factor of the credit worthiness of the borrower and the terms and conditions of the loan (e.g. tenure of loan, currency, security, etc).
- Safe Harbour interest rate may not be appropriate for a developing country like India, having high inflation and fluctuating interest rates.
- There is substantial difference in base interest rates of India and developed countries. As a result of the same, a Safe Harbour entirely based upon Indian base interest rate would not be appropriate. Further, Safe Harbour based on foreign currency base rate shall also have issues, e.g. it may not capture the cost of funds (if loan is funded from local borrowing) to the lender. Hence, in such case, even foreign base interest rate for a foreign currency loan may not be appropriate.
- Further, developing economies where Safe Harbour interest rates have been used, show substantial variation in the approach on a year on year basis, which indicate that Safe Harbour rates are not appropriate for all circumstances.

4.6.1.1 The Committee has noted the above concerns and, while acknowledging stakeholder view that interest on a loan is dependent on various factors like credit worthiness of the borrower, the tenure of the loan etc, is of the

view that these factors can be taken care of while designing the Safe Harbour. The remaining concerns are considered in seriatim as follows:

- The concern that interest rate is dependent on the credit worthiness of the borrower and the terms and conditions of the loan are taken care of by benchmarking against Indian rate and also by fixing different Safe Harbour interest rates depending on the credit rating of the AE borrower.
- The next concern is that Safe Harbour interest rate may not be appropriate for a developing country like India, having high inflation and fluctuating interest rates. The Committee is proposing a Safe Harbour linked with Base Rate, the fluctuations in interest rates attributable to any economic factor, including high inflation will be automatically taken care of as Banks review Base Rate every quarter.
- The concern that developing economies, where Safe Harbour interest rates have been used, show substantial variation in approach on a year on year basis, has also been considered by the Committee. It will be evident from its recommendations that Safe Harbour interest rate being fixed with reference to Base Rate will take care of the variations.
- Also the flexi-policy design suggested by the Committee indicates that these Safe Harbour rates need to be reviewed every year, after the initial two-year period, by creating an institutional mechanism. Depending on the administrative experience so gained, the implementation can be modified/ fine-tuned.

4.6.1.2 The fact is that countries are thinking in this direction. The Australian Tax Office had put an unclassified discussion paper in June 2008 in public domain titled "Intra-group finance guarantees and loans - Application of Australia's transfer pricing and thin capitalization rules". In September 2012, American Bar Association section of taxation filed its informal comments and recommendations for guidance pertaining to the transfer pricing of related

party guarantees with US IRS. In the view of the Committee, the above concerns can be met through the flexi-policy design of Safe Harbour being adopted by the Committee. So the concerns expressed appear to be premature

4.6.1.3 The Committee is of the view that Safe Harbour interest rates on outbound loans will bring in certainty, clarity and transparency in these uncertain economic times in the tax positions for assessee as well as the Department thereby reducing litigation.

4.6.2 Whether there should be any moratorium in the initial period when the AE is in start-up phase, say, for three years?

4.6.2.1 Sometimes, the assessees tend to argue before the TPOs that no interest is being charged on the outbound loans given to overseas subsidiary or AE as it is in a start-up phase and the Parent has to support it in the initial period. In such a situation, if interest were charged, it would only increase the burden on the subsidiary / AE, increasing the loss in the start-up phase. Additional capital would have to be infused by the Parent to fund the loss arising on account of interest, if charged on such loans. So the charging of interest would be counterproductive in such circumstances.

4.6.2.2 The Committee is of the view that when applying the arm's length principle, the parent and subsidiary relationship is to be ignored, as no independent party would advance a loan without any interest being charged during the start-up phase of the borrower, unless the lender is compensated more in the period subsequent to the moratorium period. Further, the issue of whether the subsidiary or the AE is in start-up phase is a fact intensive exercise which can be carried out only by the TPO. If the assessee feels that non-charging of interest is justifiable due to start-up phase of the subsidiary even though same is not at arm's length, the same can be presented by the assessee before the TPO with proper transfer pricing documentation like justifying with a

higher interest rate subsequent to the moratorium period. In these circumstances, the assessee may not opt for Safe Harbour.

4.6.3 Present Practice in India

4.6.3.1 The Committee took note of the present practices followed by the TPOs. The details of adjustments by the TPOs across the country on account of loan transactions are given as **Annexure –V** to this Report.

4.6.3.2 Generally the most appropriate method adopted in intra-group loans is Comparable Uncontrolled Price (CUP) Method, but there is no uniformity in the approach to benchmark interest chargeable on outbound intra-group loans. The TPOs have been using the following interest rates prevailing in the Indian market:

- Prime Lending Rates of Nationalized Scheduled Banks such as SBI (up to 14% p.a.)
- Yields on Corporate Bonds of similar maturity as that of loan and similar credit rating as that of the AE (up to 17% p.a.).
- Interest rate on borrowings of the assessee, with mark-up for bearing risks such as credit risk, foreign exchange fluctuation risk and also profit element for the assessee in such financial transactions (up to 12-13% p.a.).

4.6.4 Interest Rate to be applied for benchmarking

4.6.4.1 As seen above, TPOs generally face problems in terms of which interest rate is to be adopted for benchmarking. Whether the interest rate should be linked with PLR (Prime Lending Rate) /Base Rate in India or the cost of borrowing for the assessee with certain additional rate for the risk and return or the corporate bond yields in India? Whether foreign AEs credit rating is material for the analysis or not is also an issue.

4.6.4.2 On the other hand, the assessees, in general, argue that the interest rates on outbound loans should be benchmarked against LIBOR of corresponding currency in which the loan is availed by the foreign AE as the loan advanced to the AE is in foreign currency and foreign currency loans are usually benchmarked against international benchmark rates such as LIBOR, EURIBOR, etc.

4.6.4.3 Consequently, the main issue that has been considered by the Committee is whether the loans given out of Rupee Funds, among related parties, should be subjected to domestic benchmark interest rates or international benchmark rates. To understand this issue, the Committee considered the following aspects embedded in such transactions in an arm's length situation:

S. No.	Aspect for consideration	Lending money by X (an Indian entity) to Y (being foreign AE)
1	Primary Consideration	The primary consideration for X is to maximize its return in terms of interest keeping in view the risk involved along with costs incurred and benefit derived.
2	Interest Rate	Interest rate depends on the tenure, credit worthiness of Y, and security offered.
3	Benchmarking	The benchmarking would be based on the interest rate receivable in India.

4.6.4.4 Thus, the Committee is of the view that for benchmarking purpose, interest rate for lending should be different from that for borrowing. In this context, the Committee recommends adoption of domestic interest rates in case of loans sourced from Rupee funds mainly for the following reasons:-

- In the case of a Rupee sourced lending transaction, the aim of the lender is to maximize the interest rate that he can get, keeping in view the risk potential along with costs and benefits. The lender in India would try to benchmark his return with the domestic interest rate rather than interest rates prevailing in developed countries as interest rates in other currencies (such as USD, CAD, and EURO,) which are usually benchmarked with LIBOR , are historically very much lower than benchmark interest rates prevalent in India(like PLR, Base Rate or Yields on Government Bonds).
- As Indian currency is not freely tradable across the globe, in a loan transaction, the Rupee is invariably converted to any other freely tradable currency such as USD, GBP etc, other than those loans which are lent from foreign currency sources of Indian entity like export proceeds, proceeds from ECBs (External Commercial Borrowings) raised abroad. Thus, effectively, the source of the loan, in most cases, is Indian Rupees, but is converted to USD or other currency at the time of remittance to the AE. Thus, these outbound loans are effectively Rupee loans and not foreign currency loans, as the source of the loan is Indian Rupee. The important fact not to be lost sight of is that the transaction to be benchmarked is of loan and not its conversion into foreign currency. In this case the, Indian entity is bearing foreign currency risk arising on account of fluctuation of Indian Rupee vis-à-vis the currency in which the payment of loan is made to the foreign AE.
- The ideal interest rate on outbound intra-group loans would be that interest rate which would have been charged by independent parties dealing in similar circumstances and during the same period of time. Factors to be considered are type of credit, collateral, credit worthiness, currency etc. However, this data would not be available in uncontrolled conditions, as RBI does not permit Indian enterprises to give loans to any entity, other than their wholly owned subsidiaries or Joint Ventures.

Further, it is not prudent at arm's length to lend to a foreign enterprise in foreign currency from India, as generally the gap between interest rates in foreign currencies and in India have always been significant. Even RBI prohibits the banks from lending in foreign currency out of Rupee funds available with them. In these circumstances, it is almost impossible to get any unrelated or uncontrolled transaction, in which an Indian entity has lent to any unrelated entity outside India, for comparability analysis.

- As the Indian entity, which is usually in a better bargaining position as a lender vis-à-vis its WOS / JVs as a borrower, is lending to another party, an important aspect would be the interest rate expected by the lender. This would be the interest prevalent in India or opportunity cost of such funds if they were invested either in the business or other forms of investment. Thus, one necessarily needs to go into finding hypothetical CUP rate based on cost of funds or opportunity cost of funds blocked in such intra-group loans. If any Indian entity had invested such sums in India with Banks, then the deposit rate would be that from India. If the same were invested in any other investment e.g. stocks, mutual funds or real estate, depending on the risk appetite of the entity, the corresponding return would still be reflective of interest rates in India. If the Indian entity did not have sufficient surplus funds to lend, it may borrow such funds from banks or others, then the cost of borrowings in India would also be relevant. Besides, if the surplus funds were to be invested in existing business or expansion into new businesses, the return would also be linked with domestic interest rates. So, the entire gamut of cost to the Indian entity or opportunity cost to the Indian entity will always be with reference to the interest rates prevailing in India.

4.6.4.5 The Committee has also noted that wherever Safe Harbours have been provided in other countries for outbound loans, they are also based on their domestic interest rates. Some of the Safe Harbour interest rates are linked with LIBOR but only in those countries whose currencies are quoted in LIBOR.

4.6.5 Benchmark Interest Rate Options considered by the Committee:

4.6.5.1 As mentioned above, the Committee is of the view that domestic interest rates are relevant for outbound loans sourced from Rupee funds. After examining the existing practice in India as well as domestic regulations relating to investments and remittances abroad, the Committee considered the following 2 options.

- Adoption of prevailing Base Rate notified by banks as per formula / guidance laid down by Reserve Bank of India **(Annexure –VI)** for Safe Harbour.

OR

- Adoption of prevailing yield / rate of interest on dated Government Securities of similar maturity, as provided under Companies Bill, 2011 for inter-corporate loans

4.6.5.2 The Committee, in its meeting with Officers of RBI, took note of the fact that Base Rate is applicable to all the banks from 1st July 2010 and replaces the erstwhile system of Prime Lending Rate (PLR). In order to exercise the option, it is important to understand what is a base rate and why was the base rate introduced. The relevant details are given hereunder.

- Base rate is the minimum interest rate of a bank, below which it cannot lend. The Base Rate system is aimed at enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy. It has to be disclosed publicly and also makes pricing more transparent as banks are not permitted to lend below the base rate. Consequently, it has replaced BPLR system, introduced in 2003, which fell short of its original objective of bringing transparency to lending rates. Thus, the RBI brought the concept of Base Rate from 01-07-2010 and issued Guidance on Base Rate on April 09, 2010, by way of Circular No.

RBI/2009-10/390. The suggested calculation methodology of Base Rate as notified by RBI is at **Annexure -VI**.

- The major features of Base Rate covered under the guidance circular considers all those elements generally included in the lending rates that are common across all categories of borrowers such as cost of funds, negative carry on CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio), overhead costs and average return on net worth.
- The RBI has specified a methodology to compute Base Rate for a Bank **(Annexure-VI).** However, Banks are free to use any other methodology, as considered appropriate, provided it is consistent with the above and made available for supervisory review/scrutiny, as and when required.
- Banks may choose any benchmark to arrive at the Base Rate for a specific tenor that may be disclosed transparently.
- Banks may determine their actual lending rates on loans and advances with reference to the Base Rate and by including such other customer specific charges as considered appropriate.
- All categories of loans should henceforth (from 01-07-2010) be priced only with reference to the Base Rate. However, the following categories of loans could be priced without reference to the Base Rate: (a) DRI advances (b) loans to banks' own employees (c) loans to banks' depositors against their own deposits.
- Banks are required to review the Base Rate at least once in a quarter with the approval of the Board or the Asset Liability Management Committees (ALCOs) as per the bank's practice.

4.6.5.3 The choice between the two rate options as provided above requires careful analysis. It must be kept in mind that interest rate on Government securities, which have the highest safety rating, tends to be lower than the Base

Rate. Base Rate also has elements of commercial consideration in-built into its structure.

4.6.5.4 In view of the Committee, Base Rate may be the favoured option along with appropriate add on rate (for risk) for loan transactions sourced in INR, as it is commercially calibrated and captures all the currency and monetary policy concerns of the Government and, thus, provides a better measure for comparability analysis at arm's length.

4.6.5.5 6-month LIBOR may be the preferable option for loan transactions sourced from foreign currency in which LIBOR quotes are available. However, as there is no major dispute on the issue of outbound loans sourced in foreign currency, the Committee is of the view that there is no need to specify Safe Harbour rate for outbound loans sourced in foreign currency.

4.6.5.6 In this context, the Committee also took note of the judicial pronouncements, mainly at the level of Tribunals, which have provided diverse guidance on the issue. Details are given at **Annexure – VII.**

4.6.6 Risk and the interest rates

4.6.6.1 When any bank lends to a customer, it lends at a premium over and above the Base Rate to include the credit risk and also tenure risk. Similarly, while dealing at arm's length, the lending party would have to consider premium for the credit risk it is undertaking along with tenure risk. In view of the above, the Safe Harbour interest rates for outbound loans must also carry Credit Spread over and above the benchmark base rate. A credit spread is that part of the interest that, among other things, serves as a fee for incurring the credit risk.

4.6.6.2 Briefly stated, the credit spread is required over and above benchmark rate for the following reasons:-

i. Base rate is a benchmark-lending rate and banks usually do not lend at their base rate and that also without any security.

ii. No security is usually provided by the AEs in the intra-group loans.

iii. Generally, it is seen that the credit worthiness of the AE is significantly lower than that of the parent.

iv. The Indian entity that is advancing loan is also bearing tenure or term risk arising out of fluctuation of interest rates during the tenure of the loan.

4.6.6.3 A credit spread must be added to the underlying benchmark rate in order to arrive at Safe Harbour interest rate. Prima facie, base rate plus credit spread does include all elements necessary for transfer pricing analysis.

4.6.6.4 Most of the outbound intra-group loans are unsecured, meaning thereby no security has been offered by the borrowing AE. An unsecured loan is similar to unsecured corporate bonds raised by companies from market. The corporate bonds are subject to credit risk in addition to interest rate risk. Interest rate risk refers to the risk of a bond changing in value due to changes in the structure or level of interest rates. The credit risk of a high yield bond refers to the probability of a default (i.e., debtor unable to meet interest and principal obligations) combined with the probability of not receiving principal and interest in arrears after a default. Since Safe Harbour interest rates are being designed for intra group loans, they have to necessarily factor in the risks as discussed above.

4.6.6.5 The Committee took note of CRISIL data regarding the corporate bond yields for F.Y 2007-08 and FY 2008-09. As can be seen from the level of safety and risk and also the corresponding average corporate bond yields **(Annexure-IX-A & IX-B),** the credit risk of the assessees, while advancing a loan to its WOS, is classified in the following categories based on the credit rating of WOS (as per rating methodology contained in SEBI instruction dated 15.06.2011**(Annexure IX-C)** and aligned to by CRISIL):-

i. Low Risk – Adequate Safety to Highest Safety (A to AAA)

ii. Medium Risk – Moderate Safety (BBB-, BBB, BBB+)

iii. High Risk – Inadequate safety to default (BB)

iv. Junk – Substantial Risk to Default (C & D)

4.6.6.6 For the purpose of calibration, the data on corporate bond yields for the F.Y 2011-12 in India has also been examined for various levels of risks, associated with the credit ratings. The relevant extract is reproduced, as under, for ready reference (***Source: Indian Corporate Bond Market – An Analytical Perspective by Golaka C Nath, Clearing Corporation of India Ltd – June 2012***): [5]

Table - 13: Bond Issuances - Rating Class and Coupon (sample - 1285 bonds) - 2011-12							
Credit Rating	Issues	Maturity (Years)	Coupon / Yield (%)	Gilts Comparable Maturity (Year)	Yield of Comparable Gilts (%)	Risk Premia (%)	Premia over Rating Class (%)
(A)	(B)	(C)	(D)	(E)	(F)	(F)= D - F	(G)=D2-D1
AAA	506	6.56	9.54%	6.5	8.40%	1.14%	
AA	638	4.32	10.62%	4.5	8.39%	2.23%	1.08%
A	118	4.96	11.90%	5	8.40%	3.50%	1.27%
BBB	14	3.99	12.95%	4	8.39%	4.56%	1.06%
BB	6	4.01	14.38%	4	8.39%	5.99%	1.43%
P1	3	0.93	10.54%	1	8.29%	2.25%	
P2	1	1.00	9.70%	1	8.29%	1.41%	

4.6.6.7 From the above, it is seen that the spread between each category of risk is as under:

i. Low Risk (A to AAA) and Medium Risk (BBB-, BBB, BBB+) is 2.26% (12.95% - 10.69%)

ii. Medium Risk (BBB-, BBB, BBB+) and High Risk – Inadequate safety to default (BB) is 1.43% (14.38% - 12.95%)

4.6.6.8 The information on junk bonds (with credit rating of C & D) is not available in the public domain. However, as per the FIMMDA (Fixed Income Money Market and Derivatives Association of India), for bonds and debentures, which are not rated by a rating agency or have become 'unrated' during their tenor, but a corresponding rated bond of the issuer exists, then:

[5] https://www.ccilindia.com/Documents/Rakshitra/2012/June/Article.pdf

1. The unrated bonds will be valued by marking up the credit spread by a minimum of 20% over the equivalent rated bond of similar tenure.

2. For the above purpose, "corresponding" would mean, if the unrated bond has a maturity of 't' years, the rated bond should have a maturity not less than t - 0.5 years. For example, if the unrated bond has a residual maturity of 3 years, then the rated bond to be treated as corresponding should have a maturity of at least 2.5 years.

4.6.6.9 Thus, the yield on unrated bonds (C&D) can be taken, on a reasonable basis, as 20% more than the lowest graded bond rated as 'BB'. Thus, yield on junk bonds for the F.Y 2011-12 can be considered at 17.26% (120% of 14.38%) and the spread between High Risk (BB) and Junk (C&D) can be considered at 2.88% (17.26% - 14.38%).

4.6.6.10 These differential yields on corporate bonds of various risk categories, based on the data for the F.Y 2011-12, have been used to fix the premium for credit spread while fixing the Safe Harbour interest rates.

4.7 Recommendations

4.7.1 The international practices in this sector have already been discussed in the earlier part of this report. The flexi-policy design of Safe Harbour being proposed now by the Committee is as is appropriate and suited to our economic, regulatory and administrative environment.

4.7.2 The Committee, keeping in view the existing provisions of the Act and the directives as contained in the press release by PMO dated 30.07.2012, is of the opinion that the Government may consider the recommendations contained in para 4.7.3 and 4.7.4 while framing Safe Harbour Rules for Eligible Enterprises opting for Safe Harbour in respect of outbound intra-group loans denominated in INR.

4.7.3 General Recommendations

4.7.3.1 Safe Harbour provisions should be applicable to all the enterprises that are advancing loans to associated enterprises located outside India and which are sourced in INR except as per exclusions provided.

4.7.3.2 An enterprise eligible for Safe Harbour may be called an 'Eligible Enterprise' and all the loan transactions that are eligible for Safe Harbour may be called 'Eligible International Transactions'.

4.7.3.3 The assessee should have the option of whether to go in for Safe Harbour or not and it should not be mandatory. However, Safe Harbour should not become a rebuttable presumption for an assessee who opts not to go for it and has an ALP below the Safe Harbour. There has to be a directive to the Assessing Officer/TPO in this regard that they can get the international transactions bench-marked but cannot force the assessee to rebut the presumed ALP.

4.7.3.4 Safe Harbour would not be available to an assessee who has charged interest rate higher than the Safe Harbour interest rate on account of its contracted price and such an assessee cannot be assessed at the lower presumptive arm's length interest rate corresponding to the Safe Harbour.

4.7.3.5 Safe Harbour for loans may be made applicable prospectively from A.Y 2013-2014, for a period of two years.

4.7.3.6 Safe Harbour interest rates recommended may be made applicable both for continuing and new Eligible International Transactions (loans).

4.7.3.7 Once the Safe Harbour interest rate is opted for by an assessee, no price variation benefit under Section 92C or any other comparability adjustment would be permitted.

4.7.3.8 It is clarified that Safe Harbour interest rate would not lead to immunity from scrutiny of any international transaction other than the Eligible International Transactions that have been opted by the Eligible Enterprise to be covered under Safe Harbour.

4.7.3.9 Further, an institutional mechanism needs to be evolved so that the Safe Harbour rules / rates are periodically reviewed, after two years, based on the dynamic base rate concept of the banks.

4.7.3.10 The existing threshold limit of Rs. 1 crore provided under sub-rule 2 of Rule 10D was fixed more than a decade ago. An upward revision in line with earlier report is also justified to adjust for inflation. It may be mentioned that change in monetary parameters on account of inflation factor is part of our tax policy as is evident from the fact that the monetary limit for audit of accounts of certain persons engaged in business, as provided in section 44AB of the Income-tax Act itself, has been revised upwards from Rs. 40 lakhs to Rs. 1 crore during the corresponding period. Accordingly, the Committee recommends that the exemption from maintaining information and documentation for international transactions specified at Rs. 1 crore under sub-rule 2 of Rule 10D of the Income-tax Rules be raised to Rs 5 crore as it will reduce compliance cost for small assessees. Tax administration will have a smaller basket for picking up cases for scrutiny facilitating optimum use of its resources and improved risk management.

4.7.3.11 The present practice of authorizing the AO to do transfer pricing audit in select number of cases, where the aggregate value of international transactions is less than the threshold limit (Rs. 15 crore) has reduced the applicability of the threshold limit as a Safe Harbour while simultaneously diluting the effectiveness of transfer pricing audit. The Committee, therefore, recommends that the threshold of Rs.15 crore as an administrative Safe Harbour should be specified as a statutory Safe Harbour rule itself.

4.7.4 Specific recommendations:-

4.7.4.1 As already discussed above, the Committee recommends that the Safe Harbour interest rate for outbound intra-group loans sourced in the local currency i.e., INR, should be the domestic rate linked with base rate concept of

the banks. Base Rate has to be followed by all banks operating in India, with effect from 1.7.2010 and can be considered as the basic benchmark rate for domestic interest rate. This will lead to certain amount of stability, clarity and commonality in rates for benchmarking interest on loans sourced from Rupee funds with additional credit spread based on risk premium as given below.

4.7.4.2 The Committee took note of the variation in Base Rate among various public sector and private sector banks operating in India. The variation has arisen mainly due to the differences in cost of funds. So, the Committee deliberated upon the issue of the Base Rate of which bank to adopt. After deliberations, the Committee decided that State Bank of India, with a 200 year history, being the largest commercial bank in India in term of assets, deposits, profits, branches, customers and employees, would be the ideal choice. Government of India is the single largest shareholder of this fortune 500 entity. (Source: http//www.sbisyd.com.au/) in SBI. As of March 2012, it had assets of US$360 billion and 14,119 branches, including 173 foreign offices in 37 countries across the globe, including the branches that belong to its associate banks.,

4.7.4.3 The Committee also noted that the RBI stipulates that Base Rate should be reviewed every quarter by the banks and that the variation of Base Rate over the various quarters in a year and among different banks is not significant in recent times **(Annexure- VIII A&B)**. Keeping the above in view, the committee recommends that the benchmark rate shall be the Base Rate of SBI for the first quarter of the financial year i.e. as on June 30 of the relevant financial year.

4.7.4.4 The Committee also took note of a possible choice between Base Rate of SBI and that of the assessee's bank, since all banks operating in India have to follow base rate from 01.7.2010. However, the assessees may have multiple banks leading to variability in application of Safe Harbour interest rates as Base Rate differs from bank to bank. This is evident from data for base rates available in public domain (Illustrative data can be seen in **Annexures VIII-A & B).** The relevant URL for the same is http://in.reuters.com/article/2012/08/31/india-int-

base-idINL4E8JV3RB20120831. Therefore, the Committee is of the view that Base Rate of SBI may be adopted for Safe Harbour interest rates so that there is certainty and no ambiguity in the application of Safe Harbour interest rates.

4.7.4.5 It is an acknowledged fact that interest rate is dependent on credit worthiness of the borrower. However, it is felt that the process of getting a credit rating of the WOS, only for the purpose of transfer pricing, may impose a financial burden on small companies. The Committee, therefore, recommends that for loan transactions upto Rs 50 crore in respect of each AE, interest rate on outbound loans that are sourced in Indian Rupees is to be linked with Base Rate as determined by SBI plus 150 basis points, independent of the credit rating of the WOS. The 150 basis points are added to the Base Rate to cover risks such as credit risk, lack of original / collateral security, tenure risk, and operational cost. Above this loan transaction limit of Rs. 50 crore, in respect of each AE, the basic rate will be the same with additional basis points being added with reference to the category of risks for the AE. Base Rate of SBI is to be taken as on the last day of the first quarter of the financial year i.e. as on June 30 of the relevant financial year.

4.7.4.6 Safe Harbour interest rates for loan transactions above Rs. 50 crore, in respect of each AE, must be dynamic, based on, in addition to the Base Rate, credit risk and other risks embedded therein as well as ratings of the borrowing AE.

4.7.4.7 As discussed earlier, the credit risk of the assessees, while advancing a loan to its WOS, is classified in the following categories based on the credit rating of WOS (as per rating methodology of CRISIL):-

i. Low Risk – Adequate Safety to Highest Safety (A to AAA)

ii. Medium Risk – Moderate Safety (BBB-, BBB, BBB+)

iii. High Risk – Inadequate safety to default (BB)

iv. Junk – Substantial Risk to Default (C & D)

4.7.4.8 The above categorization corresponds to CRISIL's credit ratings of AAA, and BBB and their variants. It may be mentioned that CRISIL is India's leading rating agency with 70% market share and is fourth largest in the world. It also offers sectoral specialization and hence, provides comprehensive range of rating services **(Annexure IX-B).** The ratings by CRISIL and other Credit Rating Agencies such as ICRA, FITCH and CARE have also been aligned with the SEBI instructions dated 15.06.2011 **(Annexure IX-C).**

4.7.4.9 As discussed earlier, it is seen that the spread between each category of risk is as under for corporate bond yields during the FY 2011-12:

i. Low Risk (A to AAA) and Medium Risk (BBB-, BBB, BBB+) is 2.26% p.a. (12.95% - 10.69%)

ii. Medium Risk (BBB-, BBB, BBB+) and High Risk – Inadequate safety to default (BB) is 1.43% p.a. (14.38% - 12.95%)

iii. High Risk (BB) and Junk (C&D) can be considered at 2.88% p.a. (17.26% - 14.38%).

4.7.4.10 These differential yields on corporate bonds of various risk categories, based on the data for the FY 2011-12, are being used to fix the premium for credit spread while fixing the Safe Harbour interest rates.

4.7.4.11 The Committee, therefore, recommends keeping the basic rate at the Base Rate of SBI as on the last day of the first quarter of the financial year i.e. as on June 30 of the relevant financial year. Where the total loan transaction is above Rs 50 crore, this Base Rate will then be calibrated to arrive at Individual Safe Harbour interest rates for low, medium, high risk and junk categories of WOS. This has been done by drawing inference through CRISIL ratings and yield spreads as given above.

4.7.4.12 Based on the above analysis, the recommendation for Safe Harbour interest rates is as under:-

A: For loan transactions below Rs. 50 crore

Sl. No	Description	Rate
1.	Safe Harbour Interest Rate	Base Rate* plus 150 basis points per annum.

B: For loan transactions of or above Rs. 50 crore

Sl. No	Description	Rate
1.	Low Risk WOS	Base Rate* + 150 Basis Points per annum
2.	Medium Risk WOS	Base Rate* + 400 Basis Points per annum
3.	High Risk WOS	Base Rate* + 550 Basis Points per annum
4.	Extremely High Risk (Junk) WOS	Base Rate* + 800 Basis Points per annum

*** In case of fixed rate loans, the Base Rate shall be based on the Base Rate as on the date of the loan agreement or 01-07-2010, whichever is later.**

In case of floating rate loans, the Base Rate shall be the Base Rate published by the SBI as on the last day of the first quarter i.e., 30th June, of the relevant financial year.

4.7.4.13 The Committee recommends that the Credit rating of the borrowing AE should be the rating as on the date of advancing the loan. One of the Committee Member's, Mr. Kanabar, is of the view that if the borrowing AE is an SPV, which is not independently rated, then the rating of the operating company, where the funds are utilized, will be taken as the rating of the SPV. This issue was discussed and the other members of the Committee do not agree with his view.

4.7.4.14 The Committee recommends that the Most Appropriate Method to be applied is CUP and the Safe Harbour interest rate under CUP method is to be arrived at as shown in the above table.

4.7.4.15 The Committee is of the view that since joint ventures are between related parties that share risks as well as resources including labour skills, target market, reputation of JV (Joint Venture) partner etc, it is difficult to cover loans to them under Safe Harbour rules. As the risk factor is uncertain and is fact dependent, therefore, JVs should be excluded from Safe Harbour**.** The Committee recommends that the Safe Harbour interest rates are to be provided for outbound loans only in case of wholly owned subsidiary (WOS), including a SPV (Special Purpose Vehicle).

4.7.4.16 The Committee recommends that Safe Harbour interest rates on both floating and fixed rate loans be linked to Base Rate of SBI. However, as fixed rate loans carry a fixed interest rate over the period of loan, the Committee recommends that Safe Harbour interest rates for such loans be based on Base Rate as on the date of the loan agreement or 01-07-2010, the date from which the Base Rate is adopted by RBI, whichever is later. Similarly, the Committee recommends that Safe Harbour interest rates for floating rate loans be based on Base Rate as on the last date of the first quarter of the relevant financial year. In the case of non-interest bearing loans, the Committee recommends that Safe Harbour interest rates for such loans be based on Base Rate as on the last date of the first quarter of the relevant financial year.

This has been elaborated as follows in the FAQs on Base rate on ING Vysya Bank website:

Quote

"13. How will change in base rate impact floating loans interest rates?

Any change in base rate will affect the floating rate of interest of loans that are linked to the base rate. For example, if floating rate of interest is 11% (Base rate 9% + margin 2%) and if the base rate increases to 9.25%, the floating rate will be

11.25 (base rate 9.25% + Margin 2%). Similarly, a fall in the base rate will lead to a fall in the applicable floating rates.

14. Is it compulsory for borrowers who have availed fixed rate loans to opt Base Rate?
No. But it is advisable to do so."

Unquote

4.7.4.17 For the purpose of clarity on the recommendations made by the Committee on Safe Harbour interest rates, the following illustrations are provided herein:

Illustration 1: *An Indian enterprise 'A' advanced a loan in USD equivalent to Rs 150 crores to its foreign associated enterprise 'B' located in USA on 01-01-2008 for a period of 7 year and the source of the loan is Indian Rupees. The credit rating of B on standalone basis is 'BBB' (Medium Risk) and the loan is based on floating interest rate. Then the applicable Safe Harbour interest rate is Base Rate of SBI as on the last date of 1st quarter i.e. 30-06-2012 + 400 bps for the FY 2012-13, relevant for the AY 2013-14. Let us say, the Base Rate as published by SBI on 30-06-2012 is 10.25% p.a, then the Safe Harbour interest rate is 14.25% p.a (10.25% + 400 bps).*

Illustration 2: *An Indian enterprise 'A' advanced a loan in USD equivalent to Rs. 200 crores to its foreign associated enterprise 'B' located in Canada on 01-10-2009 for a period of 5 years and the source of the loan is Indian Rupees. The credit rating of B on standalone basis is 'BB' (High Risk) and the loan is based on fixed interest rate. Then the applicable Safe Harbour interest rate is Base Rate of SBI as on 01-07-2010 + 550 bps for the FY 2012-13, relevant for the AY 2013-14. Let us say, the Base Rate as published by SBI on 01-07-2010 is 7.50% p.a i.e. Safe Harbour interest rate is 13.00% p.a (7.50% + 550 bps).*

Illustration 3: *An Indian enterprise 'A' advanced a loan in USD equivalent to Rs. 250 crores to its foreign associated enterprise 'B' located in Australia on 15-08-2011 for a period of 5 years and the source of the loan is Indian Rupees. The credit rating of B on standalone basis is 'A' (Low Risk) and the loan is based on fixed interest rate. Then the applicable Safe Harbour interest rate is Base Rate of SBI as on the date of agreement i.e. 15.08.2011 + 150 bps for the FY 2012-13, relevant for the AY 2013-14. Let us say, the Base Rate as published by SBI which is applicable as on 15.08.2011 is 10.25% p.a, then the Safe Harbour interest rate is 11.75% p.a (10.25% + 150 bps).*

4.7.4.18 To reduce compliance costs for the assessees, it is imperative that the documentation burden on the assessees opting for Safe Harbour is made less stringent, as compared to an assessee choosing regular TP documentation and scrutiny by the Department. Accordingly, the Committee recommends, as in the first report, that -

A. Such an enterprise need not maintain information and documents specified in clauses (g) to (m) of Rule 10D(1) in respect of the Eligible International Transactions.

B. In addition, the eligible enterprise opting for Safe Harbour may also be required to submit the following information, in any prescribed format as may be notified by CBDT, to be certified by a Charted Accountant:

    i. The currency in which the loan is availed by the foreign AE and the currency of the source of the Loan.

    ii. Period of the loan advanced to the AE.

    iii. Purpose of the loan advanced to the AE.

    iv. If the source of the loan is Indian Rupees, then the relevant Base Rate applicable.

v. Certification of credit rating of the borrowing AE by any registered domestic or international agency such as CRISIL, ICRA, CARE, S&P, MOODY'S, Fitch, etc.

4.7.4.19 The Committee recommends following exclusions from Safe Harbour Provisions: -

- Outbound loans sourced in foreign currency
- Outbound loans of Enterprises in the nature of Financial Companies including Banks and Financial Institutions or Enterprises engaged in lending or borrowing.
- Loans to WOSs located in countries notified u/s 94A of Income Tax Act or any other country / territory widely perceived as a tax haven.
- Credit line or any loan which has no fixed term for repayment

***

PART-5: INTRA-GROUP FINANCIAL TRANSACTIONS – CORPORATE GUARANTEES

5.1 What is Corporate Guarantee?

5.1.1 The term "guarantee" is not defined under the Income-tax Act but it generally includes a reference to:

- A surety, and
- Any other relationship, arrangement, connection or understanding (whether formal or informal) such that the person making the loan [the lender] to the borrower has a reasonable expectation that in the event of default by the borrower, the lender will still be paid by, or out of the assets of, the Guarantor.

5.1.2 There are different types of Guarantees such as

- Explicit Guarantees or Corporate Guarantees
- Implicit Support or Passive Association
- Letters of Comfort
- Performance Guarantees

5.1.3 An explicit guarantee is generally provided by the parent entity essentially for bridging the gap between the credit worthiness of the parent and the AE borrowing the funds and the assurance required by the lender bank.

5.1.4 Explicit guarantees are therefore those where a direct assurance is given by an AE. It is common among Indian MNCs to extend support to subsidiaries that enable the subsidiaries to borrow funds at a cheaper interest rate, from third-party banks. The support extended by a group company may be expressly stated in the form of a financial guarantee-agreement. In such a case, the group company, which provides an explicit guarantee on behalf of its related entity, is exposed to the default risk and therefore needs to be compensated by way of an arm's length guarantee commission.

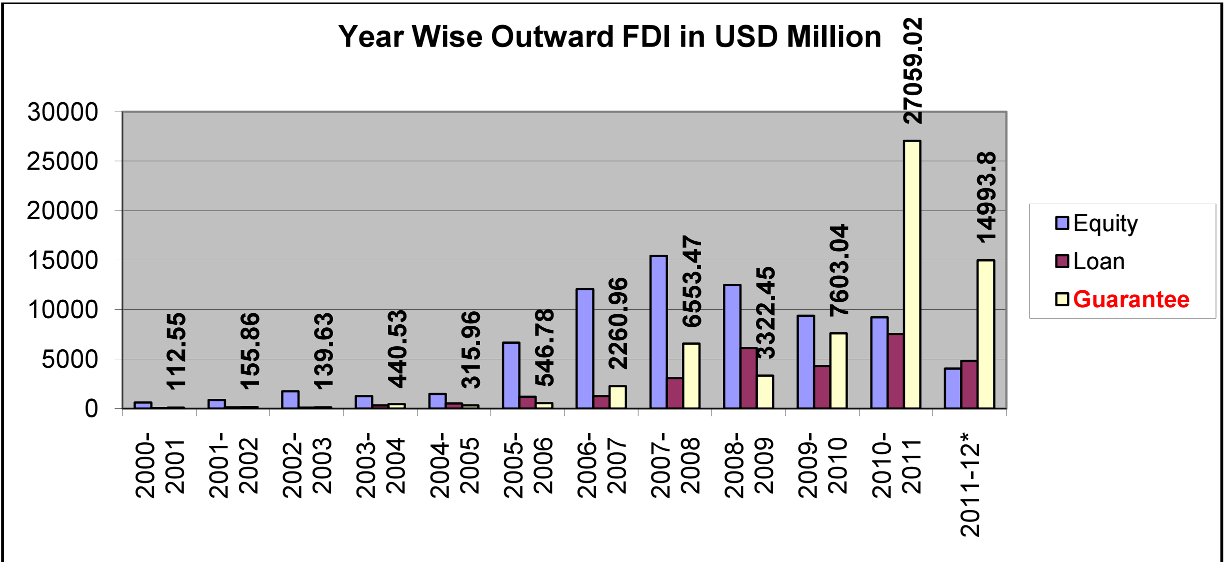
5.1.5 Guarantees are flexible and can be designed to cover the exposures the AEs want. The effect of a guarantee on the terms and conditions of loans is varied. Guarantees may help the AE borrowing funds to secure:

- A larger loan
- A lower rate of interest
- An increase in duration
- Less demanding covenants on the borrower or advantageous terms than the borrower could have obtained otherwise,

5.1.6 In the event of a borrower failing and with no guarantee in place, a third party lender's prospects of recovering its outlay would be at risk. However, with a guarantee in place, the lender would generally have greater and more immediate success in recovering debt and interest, simply by exercising its rights under the guarantee, i.e. invoking the guarantee and seeking payment from the guarantors, than it would have by waiting for a distribution of assets through liquidation or having to write- off all or part of the loan. The guarantor would of course have to demonstrate that it could make good its pledge and probably provide security in relation to its commitment.

5.2 **Growing Trend**

5.2.1 The importance of outbound corporate guarantees can be seen by the growing quantum of guarantees issued by the Indian parents to their foreign subsidiaries or joint ventures as shown in the chart below.



5.2.2 As can be seen from above, in 2010-11, the outbound corporate guarantees were to the tune of USD 27 billion or Rs. 1,21,000 crores. Due to global economic crisis and lack of liquidity in the markets, Indian companies are in favour of giving guarantees rather than contributing money by way of capital in terms of equity or debt.

5.2.3 The liberalized policy of Government and the RBI paved the way for establishing SPVs abroad for acquiring businesses through these SPVs. Some the major guarantees given in recent past are as follows:

- In June 2010, Bharti Airtel Ltd acquired Kuwait-based Zain group's Africa assets through its wholly owned subsidiary Bharti Airtel International (Netherlands) BV. In this regard, Bharti Airtel Ltd gave a guarantee of equivalent USD 5.5 billion to SPV in Netherlands.

- Reliance Industries has given guarantees worth USD 4.27 billion to its Mauritius-based wholly owned subsidiary Reliance Oil & Gas Mauritius Ltd. Mauritius, to acquire shale gas resources mainly in USA.

- Through its 100% subsidiary Jindal Steel & Power (Mauritius) Ltd., Mauritius (JSPLM), Jindal Steel & Power Limited has acquired Shadeed Iron & Steel

Co. LLC (Shadeed) in Oman, a leading steel manufacturer in the Middle East. In this respect, JSPL has given a guarantee equivalent to USD 470 million to JSPLM.

5.2.4 In view of the Committee, since the quantum and complexity of corporate guarantee transactions is increasing, a commonality of approach in benchmarking would to a certain extent bring in clarity, transparency and reduction in litigation.

5.2.5 Details of guarantees benchmarked by the TPOs in the last few years can be seen at **(Annexure – X).** A list of high value guarantees given in F.Y 2010-11 as per data on RBI website is at **(Annexure - XI.** An analysis of data furnished **(Annexure-X)** of 40 cases, involving outbound intra-group guarantees, shows that in 18 cases the quantum of guarantee amount determined by the TPOs is below Rs. 50 crore and 5 cases above Rs. 150 crore. The maximum amount guaranteed is Rs. 1336 crore. Data relating to commission charged on Bank Guarantees collected from branches of Banks located at Chandigarh, such as Axis Bank, Canara Bank, State Bank of India and Punjab National Bank for F.Y 2008-09 **(Annexures-XII A & B)** for the purpose of regular TP audits has been perused. Data for F.Y 2012-13 **(Annexure- XII B)** has also been considered. The data for F.Y 08-09 shows that the financial guarantee charges range from 1.75 % to 3.6 %, with the mean being 2.85%, on the amount of corporate guarantees extended by the banks to their customers. Data also shows that credit ratings have been taken into account for charging guarantees. Further, these rates are the upper limits and rates can be negotiated on case to case basis. As can be seen from the data, variation in the rates over a three year period has been minor.

5.3 Is Corporate Guarantee an international transaction?

5.3.1 Even prior to the clarificatory amendment w.e.f. 01-04-2002 by the Finance Act, 2012, the Department did consider Corporate Guarantee as an

international transaction, as by providing a corporate guarantee, the assessee did provide a benefit to its AE, which potentially affected the income, profits or assets of the parties concerned. The assessees challenged this view and in the case of Foursoft Limited, the Hon'ble ITAT, Hyderabad held in its decision dated 09-09-2011, that corporate guarantee issued to financial institutions, on behalf of AEs, is not an international transaction.

5.3.2 After the Finance Act, 2012 introduced Explanation to Section 92B w.r.e.f. 01-04-2002, the Hon'ble ITAT, Mumbai, in the case of *Everest Canto Cylinders Vs. DCIT(LTU)*, held that the corporate guarantees are international transactions in view of the retrospective amendment. It held as under:

> *"21. So far as the learned Senior Counsel's contention that guarantee commission is not an international transaction and there could not be any method for evaluating the ALP for the guarantee commission, we do not find any merit in the said contention in view of the amendment brought by the Finance Act, 2012 with retrospective effect from 1-4-2002 by way of Explanation added in Section 92B. Payment of guarantee fee is included in the expression 'international transaction' in view of the Explanation i(c) of Section 92B."*

5.4. Regulation of Inter-Corporate Guarantees

5.4.1 Under FEMA, the RBI has issued Foreign Exchange Management (Guarantees) Regulations, 2000, which state as follows:

- Save as otherwise provided in these regulations, or with the general or special permission of the Reserve Bank, no person resident in India shall give a guarantee or surety in respect of, or undertake a transaction, by whatever name called, which has the effect of guaranteeing a debt, obligation or other liability owed by a person resident in India to, or incurred by, a person resident outside India.

- A person other than an authorised dealer may give a guarantee in the following cases, namely:

  (a) a person resident in India being an exporting company may give a guarantee for performance of a project outside India, or for availing of credit facilities, whether fund-based or non-fund based, from a bank or a financial institution outside India in connection with the execution of such project.

  (b) a company in India promoting or setting up outside India, a joint venture company or a wholly-owned subsidiary, may give a guarantee to or on behalf of the latter in connection with its business.

  (c) an agent in India of a shipping or airline company incorporated outside India may give a guarantee on behalf of such company in connection with its obligation or liability owed to any statutory or Government authority in India

5.4.2 However, the RBI does not regulate commission chargeable on provision of guarantees by Indian entities to overseas joint venture company or a wholly owned subsidiary. As per RBI's Master Circular dated 02-07-2012 [6], the total financial commitment of the Indian party, in all the Joint Ventures / Wholly Owned Subsidiaries put together, shall not exceed 400% of the net worth of the Indian party as on the date of the last audited balance sheet. Financial commitment includes 100% of amount of guarantee (other than performance guarantee) issued by the Indian party. The Indian party / entity may extend loan / guarantee only to an overseas JV/ WOS in which it has equity participation.

5.4.3 As per Section 370 of the Companies Act, 1956, no company can give any guarantee, or provide any security, in connection with a loan made by any other person to, or to any other person by anybody corporate, unless the

[6] RBI's Master Circular No. 11/2012-13 http://rbidocs.rbi.org.in/rdocs/notification/PDFs/11MD010712IFL.pdf

making of such loan, the giving of such guarantee or the provision of such security has been previously authorised by a special resolution of the lending company

5.4.4 Under Section 186(2) of the Companies Bill, 2011, no company shall directly or indirectly give any guarantee or provide security in connection with a loan to any other body corporate or person exceeding 60% of its paid-up share capital, free reserves and securities premium account or one hundred per cent of its free reserves and securities premium account, whichever is more.

5.5 Methods of benchmarking guarantee commission

The Committee took note of the following generally accepted economic methods for benchmarking intra-group guarantees:

- Yield Approach / Spread Method
- Interest Saving Method
- Capital Infusion Method
- Risk of Loss Approach or Insurance Method
- Credit Default Swap Approach
- Option pricing method

5.5.1 The first two approaches (yield method and interest saving approach) independently or in combination thereof may perhaps be the most practical method for the purpose of benchmarking guarantee commission in Transfer Pricing.

Rule 10 AB of the Income-tax Rules, which reads as follows, provides w.e.f. 01.04.2012, i.e. from AY 2013-14:

The other method of determination of arm's length price:

"[Other method of determination of arm's length price.

10AB. For the purpose of clause of (f) of sub section (1) of section 92C, the other method for determination of the arm's length price in relation of an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.]

5.5.2 The above method(s) can be applied under Rule 10AB, as there is always a contentious issue that CUP rate arrived at by the TPO based on quotations received from Banks or based on yield methods are not comparable uncontrolled transactions, rather they are hypothetical CUP rates. However, all these methods do have their limitations and the choice of most appropriate method requires careful consideration. Even the Australian Tax office in its discussion paper released in June 2008 had invited comments on applicability of various methods.

5.6 Present Practice

5.6.1 There is no uniformity in the methods hitherto adopted by the TPOs leading to conflicting stand between TPOs and assessees resulting in litigation. Generally, the following approaches, which have their limitations, have been adopted by the TPOs:

- **Bank Guarantee Commission charged by Banks**. The quotes are collected by the TPO for the relevant assessment year and used for Transfer Pricing audit **(Annexure –XII A).** As can be seen from the figures in these Annexure, the commission rates charged by the banks also vary from bank to bank. In fact the rates are also negotiated if need be on case to case basis.
- **Interest saving approach** is followed only in those cases where the guaranteed entity is capable of getting loan without the help of the guarantor and thereby saves interest. The main problems in this

approach are - i) How to reliably measure the interest rate without the guarantee; ii) Whether the AE is capable of getting a loan or amount of loan without an explicit guarantee by an Indian Parent; iii) Whether the benefit or spread of interest should be split for passive association or implicit support; If yes, how to compute such adjustment? iv) Whether the benefit or spread of interest is to be split for relative bargaining power. If yes, the method and manner of determination of adjustment, if any;

- Third approach used is the **Yield Curve Approach** (varies from 7% to 11% p.a. on the guaranteed amount outstanding and illustrative CRISIL data on yields may be seen at **Annexure IX-A**). In this approach, the consideration is the differential yield on corporate bonds corresponding to the credit rating of the parents and the subsidiary. According to Wikipedia, corporate (company) curves are constructed from the yields of bonds issued by corporations. Since corporations have less creditworthiness than most Governments and most large banks, these yields are typically higher. Corporate yield curves are often quoted in terms of a "credit spread" over the relevant swap curve**.** The main issues in this approach are - i) How to quantify the credit rating of AE on standalone basis; ii) Whether the yield on bonds should be that of India or the country in which the AE is located; iii) Whether adjustment is to be given for passive association or implicit support; If yes, how to compute such adjustment? iv) Manner of determination of adjustment, if any, for relative bargaining power;

5.6.2 These methods, individually or in combination, have been used by the TPOs. But sometimes these methods have led to unintended results, as in one case at Mumbai. In fact, this is a major Transfer Pricing case of Corporate Guarantee till date, which has been dealt by Dispute Resolution Panel (DRP-II Mumbai). Details of this decision and a recent decision of Mumbai ITAT on Corporate Guarantee are in **Annexure-XIII.**

5.7 Issues considered by the Committee

5.7.1 The Committee has noted the observations of one of the stakeholders, which has opposed Safe Harbour for corporate guarantee **(Annexure –XIV).** In the view of the Committee the aspects highlighted by the stakeholder, an accounting firm, do get clarified in the flexi policy design adopted by the Committee. Even the American Bar Association (Section of Taxation) in September 2012 in its informal comments to US IRS has stated *"Even where the benefit that an affiliate derives from a performance guarantee is slight, we recommend that the transaction be treated as compensable and that the formidable difficulties of valuation be handled by safe harbors or de minimis rules."* So, safe Harbour for compensation on corporate guarantee is apparently desirable.

5.7.2 The Committee has also noted the following difficulties in benchmarking intra-group corporate guarantees. The judgmental errors arising at times due to these problems have material and unintended impact on benchmarking commission on intra-group corporate guarantees. Some of these difficulties are:

i. General Lack of availability of accurate and reliable information in the public domain.

ii. The difficulty in arriving at reasonably accurate Credit Rating of the borrowing AE.

iii. Lack of reliable information regarding the yield on corporate bonds in the country in which the Guarantor is located or the AE is located or the currency in which the loan is availed or the country in which the lending financial institution is located.

iv. The issue of whether passive association has an effect on credit rating of the AE and if yes, to what extent such passive association improves the credit rating of the AE on standalone basis for computing benefit split.

v. The issue of whether an adjustment needs to be given for relative bargaining power of the Parent and its AE.

5.7.3 Why should only explicit guarantees be covered by Safe Harbour?

5.7.3.1 The Committee is of the view that only explicit corporate guarantees can be benchmarked by following a predetermined rate and methodology since there is greater transparency in terms of the factual matrix. Hence, Safe Harbour must be provided for such guarantees so that outbound investments of Indian corporates remain competitive and are free from litigation to a considerable extent.

5.7.4 Choice of most appropriate method

5.7.4.1 The Committee deliberated in-depth on this issue. Can the preferable method be interest saving method or yield curve approach depending on the facts and circumstances of the case so that absurd results can be avoided? Is it possible to adopt an average of the two as a CUP rate? Can the sixth option now provided under Rule 10 AB, which takes into account "*the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts*", be adopted?

5.7.4.2 Another issue was whether when fixing Safe Harbour for commission on explicit corporate guarantees, is it really necessary to provide any test for the benefit derived by the borrowing foreign AE? This factor will have a bearing on the choice of method. The Committee was of the view that if the Guarantor feels that no benefit has accrued to its AE by way of such guarantee, it can always demonstrate before the TPO that the AE did not get any benefit out of the guarantee given by it. In such a situation, the enterprise would not opt for Safe Harbour. The main intention of keeping a Safe Harbour for corporate guarantees is that explicit guarantees do provide benefit to the borrower, though the benefit may vary from case to case. So the Committee is of the view

that the benefit test is not required for explicit guarantee as, by its very nature, it provides a benefit to the giver and receiver.

5.7.4.3 The Committee considered whether the quotes provided by the assessee from its bankers are an appropriate benchmark or should quotes of a bank such as SBI be considered? Can these quotes be applied directly for using the CUP method prescribed under the Income-tax Act, 1961? Or can the CUP be derived following other methods such as Yield Approach or interest saving or their combination? In an earlier para, the present practices which includes all of them being followed in varying degree, have been discussed.

5.7.4.4 In this context, with reference to Bank quotes and whether they can be used as CUP, the Committee also took note of the observation made by the Hon'ble ITAT, Mumbai in the case of *Everest Kanto Cylinders Ltd Vs DCIT(LTU)* that there is also huge variation in the commission charged by the Banks, based on which the TPOs are arriving at the arithmetical mean. The relevant para is extracted below:

> *"20. While applying these external comparables of the Banks, the TPO has not brought anything on the record that under which terms and conditions and circumstances, the banks have been charging guarantee commission at the rate of 3%. The charging of a guarantee commission depends upon transaction to transaction and mutual understanding between the parties. There may be a case where the bank may not charge any guarantee commission, depending upon its evaluation of relationship with a particular client. Even otherwise also the TPO himself has noted that guarantee commission ranges between 0.15% to 3% in case of HSBC. The universal application of rate of 3% for guarantee commission cannot be upheld in every case as it is largely dependent upon the terms and conditions, on which loan has been given, risk undertaken, relationship between the bank and the client, economic and business interest are some of the major factors which has to be taken into*

consideration. In the present case, when the assessee has specifically stated that neither it has incurred any cost for providing the guarantee to the bank for loan taken by its subsidiary nor has undertaken any kind of risk, as it was the subsidiary company which has hypothecated its assets against the loan, the TPO has not brought anything on the record to controvert the same. He has proceeded on the premise that there is always a risk in providing the guarantee and some kind of security is needed for giving a guarantee. Such a premise of the Assessing Officer is without basis or material on record. Thus, applying the rate of 3% on the guarantee commission based on external comparables and that to be on naked quote given in the website, is uncalled for in the present case."

5.7.4.5 The Committee has noted that it is possible that a written quote from an independent third party such as a bank may not be a true CUP if the circumstances of the quote do not reflect the actual facts and circumstances in relation to the party seeking the guarantee. The reliability of such quotes will depend on the particular facts and circumstances and the context in which the quote is obtained. Hence it would require adjustments.

5.7.4.6 It is apparent to the Committee that all the methods have their limitations. In the circumstances, the Committee is of the view that despite the constraints, the CUP method is the most appropriate method. This is evident from the discussion in a subsequent part of the report.

5.7.5 Whether Rate of Guarantee Commission for SPVs, WOS and JV should be separate?

5.7.5.1 The Committee analysed the option that guarantee commission rates for SPVs could be lower subject to the condition that the dividends should be repatriated to India. However, it is very difficult to administer separate rates. Hence, for administrative convenience, the Committee feels that there may not be separate rates for WOS, which are SPVs.

5.7.5.2 In view of the Committee, guarantee commission rate for explicit corporate guarantee for WOS, including SPV, should be the same. Similar to the reasons for outbound loans, Safe Harbour for corporate guarantees may also be provided only for WOS including SPV and JVs be excluded.

5.7.6 Whether there should be splitting of savings between guarantor and guarantee?

5.7.6.1 The Committee is of the view that that a guarantee fee can be charged when there is an explicit benefit arising due to guarantee provided by the Guarantor to the borrower. Besides, this benefit may need to be split between the Guarantor and the borrower, as at arm's length, parties to the guarantee transactions bargain to share the benefit arising out of such transaction, keeping in view the relative bargaining power of each party. However, there are practical difficulties to split such benefit based on relative bargaining theory, which again would be based on so many economic factors and some estimates, as it is not possible to establish the assumptions or pin point with reasonable accuracy the splitting of such benefit. It depends and varies based on facts and circumstances of a case. However, the Committee considered proposing Safe Harbour for guarantee commission after allowing adjustments including adjustment for relative bargaining power at 50:50 split which should not be construed as a standard by the TPOs while applying arm's length principle. If any assessee feels, in the facts and circumstances of his case, that due to the guarantee provided by the guarantor, there is no benefit accruing to the borrower or that the benefit accruing to the borrower, after considering all factors, including passive association and relative bargaining power, does not justify guarantee commission at the specified Safe Harbour rate, it always has the option not to opt in for Safe Harbour and justify the same before the TPO with proper transfer pricing documentation. So, in view of the Committee, the cases of no benefit or less benefit would effectively not opt in for Safe Harbour guarantee commission rates.

5.7.7 Should there be both upper & lower limit?

5.7.7.1 An analysis of data by the Committee of 40 cases for 3 assessment years i.e, 2006-07, 2007-08 and 2008-09 provided by DGIT (International Taxation) **(Annexure-X)** indicates the following:

- 12 cases where the guarantee amount is below Rs 50 crore.
- 06 cases where the guarantee amount is between Rs 50 to 100 crore.
- 07 cases where the guarantee amount is between Rs 100 to 150 crore.
- 04 cases above Rs. 150 crore.
- The maximum guarantee amount is Rs. 1336.56 crore.
- The total guarantee amount of this 3 years sample data is Rs. 5366.27 crore.

5.7.7.2 The Committee also examined the possibility of having an upper ceiling for corporate guarantees for the purpose of Safe Harbour, as the RBI also permits remittances up to 400 % of the net worth that includes loans, equities and guarantees. However, it is seen in recent times that significant number of outbound guarantees are big-ticket guarantees and are above USD 100 million or Rs. 500 crore. So, it is felt that there need not be an upper limit but graded approach as in case of loans can be adopted. In view of the Committee, a graded approach is preferable keeping in mind the industry practice among unrelated parties including banks while charging bank guarantee commission.

5.8 General Recommendations:-

5.8.1 Keeping in view the existing provisions of the Act and the directives as contained in the press release by PMO dated 30.07.2012, the Committee recommends that:

5.8.1.1 Safe Harbour provisions for intra-group outbound corporate guarantees should be applicable to all enterprises.

5.8.1.2 An enterprise eligible for Safe Harbour may be called an 'Eligible Enterprise' and all the intra-group corporate guarantee transactions that are eligible for Safe Harbour may be called 'Eligible International Transactions'.

5.8.1.3 The assessee should have the option of whether to go in for Safe Harbour or not and it should not be mandatory. However, Safe Harbour should not become a rebuttable presumption for an assessee who opts not to go for it and has an ALP below the Safe Harbour. There has to be a directive to the Assessing Officer/TPO in this regard that they can get the international transactions bench-marked but cannot force the assessee to rebut the presumed ALP.

5.8.1.4 Further, an institutional mechanism needs to be evolved so that every two to three years, the Safe Harbour rules/rates are reviewed and notified in advance for the assessees to comply with such provisions with ease. Once the Safe Harbour guarantee commission rate is opted for by an assessee, no price variation benefit under Section 92C or any other comparability adjustment such as passive association, relative bargaining power etc would be permitted.

5.8.1.5 It is clarified that Safe Harbour guarantee commission rate would not have immunity from scrutiny of any international transaction other than the Eligible International Transactions that have been opted for by the Eligible Enterprise to be covered under Safe Harbour.

5.8.1.6 The existing threshold limit of Rs. 1 crore provided under sub-rule 2 of Rule 10D was fixed more than a decade ago. An upward revision in line with earlier report is also justified to adjust for inflation. It may be mentioned that change in monetary parameters on account of inflation factor is part of our tax policy as is evident from the fact that the monetary limit for audit of accounts of certain persons engaged in business, as provided in section 44AB of the Income-tax Act itself, has been revised upwards from Rs. 40 lakhs to Rs. 1 crore during the corresponding period.

Accordingly, the Committee recommends that the exemption from maintaining information and documentation for international transactions specified at Rs. 1 crore under sub-rule 2 of Rule 10D of the Income-tax Rules be raised to Rs 5 crore as it will reduce compliance cost for small assessees. Tax administration will have a smaller basket for picking up cases for scrutiny facilitating optimum use of its resources and better risk management.

5.8.1.7 The present practice of authorising the AO to do transfer pricing audit in select number of cases, where the aggregate value of international transactions is less than the threshold limit (Rs. 15 crore), has reduced the applicability of the threshold limit as a Safe Harbour while simultaneously diluting the effectiveness of transfer pricing audit. The Committee, therefore, recommends that the threshold of Rs.15 crore as an administrative Safe Harbour should be specified as a statutory Safe Harbour rule itself.

5.9 Specific Recommendations

5.9.1 The Committee recommends that the Government may consider the following while framing Safe Harbour Rules for Eligible Enterprises opting for Safe Harbour guarantee commission for intra-group corporate guarantees:

5.9.2 Safe Harbour is to be provided only for explicit Corporate guarantees for WOS, including a SPV but excluding JV. Implicit Guarantees, Performance Guarantees and Letters of comfort are to be excluded from Safe Harbour regime as they are fact intensive and need to be examined on case to case basis.

5.9.3 The Committee took note of the manner in which commission is charged on the financial guarantees provided by the Banks. In this regard, the guarantee commission structure for financial guarantees issued by State Bank of India, the largest bank in India, is summarized in the following table (available at https://sbiforsme.sbi.co.in/SME/services.htm?execution=e3s1 & at

https://www.sbi.co.in/user.htm?action=viewsection_opennew2&lang=0&id=0,10,547,945 **)/(Annexure XII-B):-**

Sl. No.	Item	Service Charges for FY 2012-13
1	Inland BG (Bank Guarantee) Charges	Minimum Commission – Rs. 500/- Upto Rs. 5 Cr – 2.10% p.a. Above Rs. 5 Cr and upto Rs. 10 Cr. – 1.60% p.a. Above Rs. 10 Cr. – 1.30% p.a.

5.9.4 Thus, it is apparent that guarantees above Rs. 10 crores are charged at a flat rate of 1.30% p.a. while the lowest slab above has a rate of 2.10 per cent p.a. Individual risk exposure is also one of the considerations and rates are negotiable on case to case basis. Rates are generally dependent on margin money and also credit worthiness of the customer. These rates reflect the market conditions.

5.9.5 So, in case of Corporate Guarantees, if the commission structure is higher than that charged by the Banks on BGs for the reasons listed below, it can provide the nearest approximation of the market conditions and thereby the arm's length conditions under a CUP:

i. The Indian Parent is not engaged in the business of issuing guarantees;

ii. Foreign WOS or SPVs credit worthiness is usually less than that of the Indian Parent;

iii. Corporate bonds generally have higher yields as corporations have less creditworthiness than most governments and most large banks; and

iv. Banks mitigate risk by spreading risk over multiple customers and also the Bank issues guarantees only to those customers, which are banking with it.

5.9.6 Keeping the above factors in view, it is proposed to keep step rates for recommending Safe Harbour commission rates for corporate guarantees issued by the enterprise located in India to banks / financial institutions on behalf of its foreign WOS. The step rates would then be increased by additional basis points depending upon risk categorization of WOS (borrowing entity), based on its credit rating on standalone basis. This Safe Harbour rate will then be calibrated to arrive at individual Safe Harbour for low, medium, high risk and junk categories of WOS based on CRISIL ratings **(Annexure IX A&B),** as mentioned while dealing with intra-group loan transactions. WOS includes SPV also. For the sake of clarity, the categorization of risk, as discussed while recommending Safe Harbour for loans, is also followed while recommending Safe Harbours for guarantee commission rates.

5.9.7 Securities and Exchange Board of India vide CIRCULAR No CIR/MIRSD/4/2011 June 15, 2011 **(Annexure IX- C)** has directed all Credit Rating Agencies Registered with SEBI to adopt Standard Rating Symbols and Definitions. The Committee has perused the said circular also. The credit risk of the assessees, while providing an explicit guarantee to its WOS, is classified in the following categories based on the credit rating of WOS (as per rating methodology of CRISIL):-

i. Low Risk – Adequate Safety to Highest Safety (A to AAA)

ii. Medium Risk – Moderate Safety (BBB-, BBB, BBB+)

iii. High Risk – Inadequate safety to default (BB)

iv. Junk – Substantial Risk to Default (C & D)

5.9.8 As discussed earlier, it is seen that the spread between each category of risk is as under for corporate bond yields during the FY 2011-12:

i. Low Risk (A to AAA) and Medium Risk (BBB-, BBB, BBB+) is 2.26% (12.95% - 10.69%)

ii. Medium Risk (BBB-, BBB, BBB+) and High Risk – Inadequate safety to default (BB) is 1.43% (14.38% - 12.95%)

iii. High Risk (BB) and Junk (C&D) can be considered at 2.88% (17.26% - 14.38%).

5.9.9 These differential yields on corporate bonds of various risk categories, based on the data for the F.Y 2011-12, are used to fix the yield spread / interest saved while fixing the Safe Harbour guarantee commission rates, after allowing 50% split between the assessee and its overseas WOS towards relative bargaining power.

5.9.10 There is an argument, and the committee considers it as appropriate, that in lower value transactions, benefit is to be shared. The State Bank of India provides 2.10 % as the bank guarantee commission for low value transactions. Since the benefit arising from the guarantee is to be shared between the guarantor and the foreign AE, the percentage of Safe Harbour for guarantee upto Rs. 50 crore is to be determined at 2%. Based on the above analysis, the recommendation for Safe Harbour guarantee commission rates is as under:-

A. If Quantum of guarantee issued is below Rs. 100 Crores

Safe Harbour Commission Rate	Quantum of guarantee	Remarks
2.% p.a.	Upto Rs. 50 crore	Immaterial of the Credit Rating of WOS or SPV, as the case may be
1.75% p.a.	Rs. 50 crore to Rs. 100 crore	Immaterial of the Credit Rating of WOS or SPV, as the case may be

B. Quantum of guarantee issued is of or more than Rs. 100 Crore

Quantum of Guarantee Issued	Basic Safe Harbour Commission Rate	Incremental rate
Rs. 100 to Rs. 250 Crore	1.50% p.a.	There shall be an incremental commission rate of 1.25% for low risk, 2.00% for medium risk, 3.25% for high risk and 4.50% for Junk, which is indicated by the credit rating of WOS / SPV on standalone basis.
More than Rs. 250 Crore	1.25% p.a.	

Illustration 1: *An Indian enterprise 'A' guaranteed a loan of equivalent Rs. 325 crores on behalf of its Wholly Owned Subsidiary (WOS) 'B' located in UK. The standalone credit rating of B is 'BB' (High Risk). Then the applicable Safe Harbour guarantee commission rate is 1.25% p.a + 325 bps for High Risk of BB i.e. the Safe Harbour guarantee commission rate is 4.50% p.a (1.25% + 3.25%).*

Illustration 2: *An Indian enterprise 'A' guaranteed a loan of equivalent Rs. 275 crores on behalf of its Wholly Owned Subsidiary (WOS) 'B' located in USA. The standalone credit rating of B is 'BBB' (Medium Risk). Then the applicable Safe Harbour guarantee commission rate is 1.25% p.a + 200 bps for Medium Risk of B i.e. the Safe Harbour guarantee commission rate is 3.25% p.a (1.25% + 2.00%).*

5.9.11 The year in which guarantee is initiated, an additional rate of 50 basis points is also to be charged for processing / transaction fees only for that year.

5.9.12 As already articulated, CUP is the most appropriate method in the circumstances for the Safe Harbour .

5.9.13 For the purpose of applying Safe Harbour guarantee commission rates, the credit rating of WOS as on the date of extending guarantee by the Indian enterprise to its overseas WOS is relevant.

5.9.14 The Safe Harbour rates suggested by the Committee as above is after considering all adjustments, including adjustment for passive association / implicit support, risks and relative bargaining power or benefit split. Thus, no further adjustments can be allowed while applying the above Safe Harbour rates.

5.9.15 **Documentation to be maintained -** To reduce compliance costs for the assessees, it is imperative that the documentation burden on the assessees opting for Safe Harbour is made less stringent, as compared to an assessee choosing regular TP documentation and scrutiny by the Department. Accordingly, the Committee recommends that such an enterprise need not maintain information and documents specified in clauses (g) to (m) of Rule 10D(1) in respect of the Eligible International Transactions.

5.9.16 In addition, the eligible enterprise opting for Safe Harbour may also be required to submit the following information, in any prescribed format, as may be notified by CBDT, duly certified by a Charterd Accountant:

- The sequence of events in obtaining and negotiating the terms of the loan and consequently the guarantee being provided;
- The nature and purpose of Corporate Guarantee issued by the Indian enterprise to the foreign AE. Besides, explanation on the possible effect on the parent company of not entering into a guarantee arrangement.
- The main terms and duration of Guarantee i.e. the loan and guarantee agreements;
- The currency in which the loan or other financial facility availed by the foreign AE from third party / financial institution, based on the guarantee

so provided by the Indian enterprise along with duration and rate of interest charged on such financial facility.

- The Corporate Guarantee agreement entered into between the Indian Enterprise and third party and the document related to the loan availed by the foreign AE from such third party or tripartite agreement entered into by Indian enterprise, its foreign AE and third party evidencing such corporate guarantee.
- Certification of credit rating of the AE by any registered domestic or international agency such as CRISIL, ICRA, S&P, MOODYS, Fitch etc.

5.9.17 Safe Harbour would not be available to an assessee whose intra-group guarantee commission rate is higher than the Safe Harbour guarantee commission rate on account of its contracted price and such an assessee cannot be assessed at the lower presumptive ALP corresponding to the Safe Harbour guarantee commission rate.

5.9.18 Safe Harbour guarantee commission rates recommended may be made applicable prospectively from A.Y 2013-2014, for a period of two years.

5.9.19 Safe Harbour provisions may not be applicable if the eligible enterprise provides corporate guarantee (in the nature of eligible international transactions) on behalf of any Associated Enterprise (AE) located in a jurisdiction as notified under section 94A of the Act or any other country / territory widely perceived as a tax haven.

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<u>Annexure -I</u>

PM sets up Committee to review Taxation of Development Centres and the IT Sector, Safe Harbour Provisions to be Finalised soon

July 30, 2012

New Delhi

The Prime Minister has constituted a Committee to Review Taxation of Development Centres and the IT Sector. The Committee will engage in consultations with stakeholders and related government departments to **finalise the Safe Harbour provisions** announced in Budget 2010 sector-by-sector. It will also suggest the approach to **taxation of Development Centres.**

2. The Prime Minister had earlier set up an Expert Committee on GAAR under the Chairmanship of Dr. Partho Shome to engage in a widespread consultation process and finalise the GAAR Guidelines. The response has been overwhelmingly positive.

3. While this Committee would address concerns on GAAR provisions and would reassure investors about the predictability and fairness of our tax regime, it was felt that there is still a need to address some other issues relating to the taxation of the IT Sector such as the approach to taxation of Development Centres, tax treatment of "onsite services" of domestic software firms, and also the issue of finalising the Safe Harbour provisions announced in Budget 2010.

4. Many MNCs carry out activities such as product development, analytical work, software development, etc. through captive entities in India. They exist in a wide range of fields including IT software, IT hardware, Pharmaceutical R&D, other automobile R&D and scientific R&D. These are popularly called **Development Centres**. Over 750 MNCs have such centres at over 1100 locations

in India. The reason for this large concentration of Development Centres in India is the worldwide recognition of India as a place for cost competitive, high quality knowledge related work. Such Development Centres provide high quality jobs to our scientists, and indeed make India a global hub for such Knowledge Centres. However, India does not have a monopoly on Development Centres. This is a highly competitive field with other countries wanting to grab a share of the pie. There is need for clarity on their taxation.

5. As far as **Safe Harbour provisions** are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the assessee.

6. The resolution of the above tax issues requires a comprehensive approach in which other government departments are consulted and industry bodies are taken on board. The overall goal is to have a fair tax system in line with best international practice which will promote India's software industry and promote India as a destination for investment and for establishment of Development Centres. Therefore, the Prime Minister has constituted a Committee consisting of experts from the Income Tax Department, both serving and retired, who will examine the issues in detail and submit proposals in a short time. An arm's length exercise of this nature will allay a lot of concerns in addition to the immediate resolution of issues that is necessary.

7. For this purpose, a **Committee on Taxation of Development Centres and the IT sector** has been constituted consisting of:

1) Shri N. Rangachary, former Chairman CBDT & IRDA - Chairman

2) Ms Anita Kapur, Director General (IT) - Member

3) Ms Rashmi Sahani Saxena, DIT (TP) - Member

4) Any other officer from the Income Tax Department to be co-opted by the Chairman

8. The **Terms of Reference of the Committee** will be to:

i) Engage in consultations with stakeholders and related government departments to finalise the approach to Taxation of Development Centres and suggest any circulars that need to be issued.

ii) Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector. The Committee will also suggest any necessary circulars that may need to be issued.

iii) Examine issues relating to taxation of the IT sector and suggest any clarifications that may be required.

9. The Committee will work to the following time schedule:

i) Finalise the approach to taxation of Development Centres and suggest any necessary clarifications by **31 August 2012.**

ii) Suggest any necessary clarifications that may be needed to remove ambiguity and improve clarity on taxation of the IT Sector by **31 August 2012.**

iii) Finalise Safe Harbour Rules individually sector-by-sector in a staggered manner and submitting draft Safe Harbour provisions for three sectors/sub-activities each month beginning with the first set of suggestions **by 30 September 2012.** All Safe Harbour provisions can be finalised by **31 December 2012.**

10. The Department of Revenue will provide all necessary support to the Committee to facilitate its work including office assistance and assistance to facilitate consultations.

***

Annexure-II

F.No.A. 50050/103/2012-Ad.I
Government of India
Ministry of Finance
Department of Revenue
***

New Delhi, dated the 13th September, 2012.

OFFICE MEMORANDUM

Subject: Constitution of a Committee to Review Taxation of Development Centres and the IT Sector- Reg.

***

The undersigned is directed to refer to Department of Revenue's O.M. of even number dated 3rd August, 2012 on the above cited subject and to say that considering the paucity of adequate data required to draft the rules, the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors/activities:

(i) IT Sector
(ii) ITES Sector
(iii) Contract R&D in the IT and Pharmaceuticals Sector
(iv) Financial Transactions – Outbound loans
(v) Financial Transactions – Corporate Guarantee
(vi) Auto Ancillaries – Original Equipment Manufacturers

2. In view of the above, the revised timelines for submitting the reports on Safe Harbour provisions by the Committee have been modified as under:

First Report by 15.10.2012;
Second Report by 15.11.2012; and
Final Report by 31.12.2012.

(M.L. Meena)
Joint Secretary to the Government of India

Copy to:

1. Shri N. Rangachary, Chairman of the Committee to Review Taxation of Development Centres and IT Sector. His kind attention is invited to Notes dated 12/09/2012.
2. Ms. Anita Kapur, Director General(IT), Member of the Committee.
3. Ms. Rashmi Saxena Sahni, DIT(TP), Member of the Committee.
4. Shri Dinesh Kanabar, Tax Expert, Member of the Committee.
5. Shri B.V.R. Subrahmanyam, Joint Secretary to PM.
6. PS to FM.
7. PPS to Secretary(Revenue).
8. Chairman, CBDT.

Annexure-III

F.No.A. 50050/103/2012-Ad.I
Government of India
Ministry of Finance
Department of Revenue
***

New Delhi, dated the 16th October, 2012.

OFFICE MEMORANDUM

Subject: Constitution of a Committee to Review Taxation of Development Centres and the IT Sector- Reg.

***

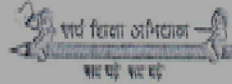
The undersigned is directed to refer to Department of Revenue's O.M. of even number dated 3rd August, 2012 on the above cited subject and to say that Ms. Anita Kapur, the then DGIT(Admn), CBDT and now Member, CBDT, will continue to be the Member of the Committee.

(M.L. Meena) 16.10.12.
Joint Secretary to the Government of India

Copy to:

1. Shri N. Rangachary, Chairman of the Committee to Review Taxation of Development Centres and IT Sector.
2. Ms. Anita Kapur, Member, CBDT.
3. Ms. Rashmi Saxena Sahni, DIT(TP), Member of the Committee.
4. Shri Dinesh Kanabar, Tax Expert, Member of the Committee.
5. Shri B.V.R. Subrahmanyam, Joint Secretary to PM.
6. PS to FM.
7. PPS to Secretary(Revenue).
8. Chairman, CBDT.

Annexure-IV



भारत सरकार GOVERNMENT OF INDIA
वित्त मंत्रालय MINISTRY OF FINANCE
राजस्व विभाग DEPARTMENT OF REVENUE
केन्द्रीय प्रत्यक्ष कर बोर्ड CENTRAL BOARD OF DIRECT TAXES

ANITA KAPUR
Member (A&J)
Tel. No.23093621

नई दिल्ली/New Delhi, the......................

D.O F.No. DIT/TP-I/89/Delhi/2012-13

Dated : October 31st, 2012

Respected Madam,

Subject: Committee to Review Taxation of Development Centres and the IT Sector under the Chairmanship of Shri N.Rangachary, Former Chairman, CBDT & IRDA – Regarding.

Kindly refer to the above and my letter dated 14/09/2012 on the same subject.

2. The Committee has submitted its second report on safe harbour provisions for the IT and ITES sectors to the Government. On behalf of the Committee, I express our gratefulness to the CBDT and the DGIT (International Taxation) for all the cooperation extended to the Committee to complete its report on time, especially providing us with valuable data from the Directorates of Transfer Pricing.

3. As the Committee now begins its work to frame Safe Harbour provisions for the remaining 4 sectors/areas (in two separate reports), its requested that DGIT (International Taxation) may be advised to expedite the data pertaining to the following sectors from the Directorates of Transfer Pricing:

- Financial Transactions - Outbound loans
- Financial Transactions – Corporate Guarantee
- Contract R & D in the IT and Pharmaceuticals Sector
- Auto Ancilliaries – Original Equipment Manufacturers

4. The time schedule for sending the data on these sectors had been mentioned in the proforma to my earlier letter as 14/9/2012. Data has been received only from a few Directorates, through the office of DGIT (International Taxation). The next report of the Committee on the financial transactions is due on 15th November, 2012. Hence this request for expediting the data. Along with the data, comments of the CBDT, if any, may also kindly be provided to the Committee for its consideration.

With regards,

Yours sincerely,

(*Anita Kapur*)

Dr. Poonam Kishore Saxena
Chairman, Central Board of Direct Taxes,
North Block, New Delhi.

Annexure-VI

Illustrative Methodology for the Computation of the Base Rate

Base Rate = a + b + c + d

a - Cost of Deposits / Funds = D_{cost}

(benchmark)

$$\text{b - Negative Carry on CRR and SLR} = \left[\left[\frac{\{D_{cost} - (SLR * T_r)\}}{\{1 - (CRR + SLR)\}}\right] * 100\right] - D_{cost}$$

$$\text{c - Unallocatable Overhead Cost} = \left(\frac{U_c}{D_{ply}}\right) * 100$$

$$\text{d - Average Return on Net Worth} = \left[\left(\frac{NP}{NW}\right) * \left(\frac{NW}{D_{ply}}\right)\right] * 100$$

Where :

D_{cost} = Cost of Deposits / Funds

D : Total Deposits = Time Deposits + Current Deposits + Saving Deposits

D_{ply} : Deployable Deposits = Total Deposits less Share of Deposits locked as CRR and SLR balances. i.e. = D * [1 - (CRR + SLR)]

CRR : Cash Reserve Ratio

SLR : Statutory Liquidity Ratio

T_r : 364 T-Bill Rate

U_c : Unallocatable Overhead Cost

NP : Net Profit

NW : Net Worth = Capital + Free Reserves

Negative Carry on CRR and SLR

$$\text{Negative Carry on CRR and SLR} = \left[\left[\frac{\{D_{cost} - (SLR * T_r)\}}{\{1 - (CRR + SLR)\}}\right] * 100\right] - D_{cost}$$

Negative carry on CRR and SLR balances arises because the return on CRR balances is nil, while the return on SLR balances (proxied using the 364-day Treasury Bill rate) is lower than the cost of deposits. Negative carry on CRR and SLR is arrived at in three steps. In the first step, return on SLR investment was calculated using 364-day Treasury Bills. In the second step, effective cost was calculated by taking the ratio (expressed as a percentage) of cost of deposits (adjusted for return on SLR investment) and deployable deposits (total deposits less the deposits locked as CRR and SLR balances). In the third step, negative carry cost on SLR and CRR was arrived at by taking the difference between the effective cost and the cost of deposits.

Unallocatable Overhead Cost

$$\text{Unallocatable Overhead Cost} = \left(\frac{U_f}{D_{ply}}\right) * 100$$

Unallocatable Overhead Cost is calculated by taking the ratio (expressed as a percentage) of unallocated overhead cost and deployable deposits.

Average Return on Net Worth

$$\text{Average Return on Net Worth} = \left[\left(\frac{NP}{NW}\right) * \left(\frac{NW}{D_{ply}}\right)\right] * 100$$

Average Return on Net Worth is computed as the product of net profit to net worth ratio and net worth to deployable deposits ratio expressed as a percentage.

Annexure –VII

Judicial Pronouncements on Benchmarking of Loans

The Committee also took note of the following judicial pronouncements, mainly at the level of Tribunals.

1. **Perot Systems TSI (India) Ltd**

Charging of interest for intra group loans is upheld by the Hon'ble ITAT, Delhi in the case of **Perot Systems TSI (India) Ltd Vs DCIT (2010-TIOL-ITAT-DEL)** wherein the Hon'ble ITAT upheld the action of TPO who charged arm's length interest on the interest free loans given to AEs, at the rate of LIBOR + 1.64 percent i.e. 4.03% percent while arriving at the arm's length prices. After considering various arguments of the assessee, it also held that real income theory is not applicable while charging arm's length interest under transfer pricing provisions contained in Chapter X. The Hon'ble Supreme Court's decision in SA Builders 288 ITR1, 82ITR835, 24ITR525 and other decisions on not taxing notional income is not applicable for Chapter X (dealing with transfer pricing provisions). The assessee's argument that AEs were in start up phase and he had to finance them, as no one would have given loans to them, was not accepted. Thin capital rule applicable in AE's country is of no relevance. The RBI's approval does not put a seal of approval on the true character of the transaction from the perspective of transfer pricing regulation as the substance of the transaction has to be judged as to whether the transaction is at arm's length or not.

2. ***VVF Ltd***

ITAT, Mumbai, in the case of ***VVF Ltd Vs DCIT (2010-TIOL-55-ITAT-MUM)***, directed the TPO to adopt the rate of interest linked with LIBOR based on internal comparables in the form of borrowings of the assessee in foreign currency as arm's length interest rate on interest free advances. In this case, the TPO was of the view that the arms length price of the interest free loans was required to be

taken at 14% p.a. In this process, the TPO took into account details of borrowings by the assessee from different sources and came to the conclusion that since advances were made out of cash credit account with Citi Bank, it was appropriate to compute the ALP as the rates on which the assessee had borrowed money from the Citi Bank in the cash credit account. This amount worked out to 14% p.a. It was also held that whether the funds are advanced out of interest bearing funds or out of funds on which 14% interest is being paid, or whether such interest free advances are commercially expedient for the assessee or not, is wholly irrelevant in this context. The transaction in the present case is of lending money, in foreign currencies, to its foreign subsidiaries. The comparable transaction therefore should be of foreign currency lending by unrelated parties.

3. Four Soft Ltd

In the case of **Four Soft Ltd,** ITA No. 1495/HYD/2010 AY 2006-07, the TPO had benchmarked the transaction related to interest on loan to AE at 14% by taking the interest rates on Corporate Bonds. The DRP directed the TPO to consider the interest using LIBOR rates. The assessee agitated before the Tribunal that the DRP has erred in taking the LIBOR rate at 5.78% whereas actually it was 4.42%. Moreover, it pleaded before the Tribunal that the correct benchmarking would be by using EURIBOR rates since the loan was given by the assessee company to a subsidiary company in Netherlands where the bank lending rates are based on EURIBOR. ITAT, Hyderabad has held that the TPO has erred in benchmarking the loan transaction using the interest rates on Corporate Bonds since the loan was an international loan and not a domestic loan. Moreover the benchmarking exercise was correctly directed to be done by the DRP using LIBOR as the same is internationally recognized and accepted and the same is not the case with EURIBOR. However with respect to determination of the correct rates of LIBOR, it remanded the matter back to the files of the department.

4. Siva Industries and Holdings

Going against the department's view, the Chennai Tribunal in the case of **Siva Industries and Holdings** ITA No.2148/mad/2010 has held that when the international transaction entered between AE is in foreign currency, then the domestic prime lending rate would have no applicability and the international rate fixed being LIBOR has to be considered. The ITAT has held that in transactions where a loan has been given to the subsidiary, CUP is the appropriate method. The ITAT has held that when the loan is given in foreign currency, the LIBOR rate may be taken as CUP.

5. Aithent Technologies Pvt. Ltd

In **Aithent Technologies Pvt. Ltd Vs. ITO** (ITA No. 3647//Del/2007 – AY 2002-03), the assessee has given periodic interest-free loans to its AE. The TPO adopted a notional interest at the rate of 10% p.a. The ITAT held that in transactions where a loan has been given to the subsidiary CUP is the appropriate method and the comparable transaction is lending in foreign currency and remanded the case back to the AO with the following directions.

Quote

> *".... considering the facts and circumstances of the case, we are of the opinion that the assessee, in the instant case, was required to comply with the provisions of the Act containing the legislation relating to transfer pricing, namely, sections 92 to 92F of the Act , with respect to the said transaction of interest free loan to its subsidiary. In the instant case, neither the AO/TPO nor the CIT(A) recorded any findings on the most appropriate method to be followed in such a transaction. In line with the reasoning in the decision in Perot Systems TSI(India) Ltd. , we are of the opinion that CUP method is the most appropriate method in order to ascertain arms length price of the aforesaid international transaction by taking into account prices at which similar transactions with other unrelated parties. For that*

purpose assessment of the credit quality of the borrower and estimation of a credit rating, evaluation of the terms of the loan e.g period of loan, the amount, the currency, interest rate basis , and any additional input such as convertibility and finally estimation of arm's length terms for the loan based upon the key comparability factors and internal and/or external comparable transactions are relevant. None of these inputs have anything to do with the costs; they only refer to prevailing prices in similar unrelated transactions instead of adopting the prices at which the transactions have been actually entered in such cases, the hypothetical arms length prices, at which these associated enterprises, but for their relationship, would have entered into the same transaction, are taken into account. Whether the funds are advanced out of interest bearing funds or interest free advances or are commercially expedient for the assessee or not, is wholly irrelevant in this context. ***The transaction in the present case is of lending money, in foreign currency, to its foreign subsidiary. The comparable transaction therefore should be of foreign currency lending by unrelated parties.*** *The AR relied on decision of Chennai Bench in M/s Shiva Industries & Holdings Ltd. and suggested to adopt LIBOR rates. However, we find that though Chennai Bench referred to LIBOR rates of 4.42%, since the assessee charged interest @6% , no further addition was made.*

7.1 Since in the instant case, neither the assessee nor the TPO/AO and the ld. CIT(A) have examined the applicability of CUP method as the most appropriate method in order to determine ALP of the international transaction of interest free foreign currency loan to its subsidiary by the assessee, we consider it fair and appropriate to vacate the findings of the ld. CIT(A) and restore the matter to the file of the AO for fresh adjudication with the directions to recompute the ALP of the aforesaid international transaction in the light of our

aforesaid observations, following CUP method, keeping in view various judicial pronouncements, including those referred to above and of course, after allowing sufficient opportunity to the assessee. Since onus is on the assessee to establish ALP of the international transaction ,the assessee shall also provide all necessary relevant inputs for establishing ALP of the transaction in accordance with CUP method. With these directions, ground nos. 1 to 5 in the appeal are disposed of."

Unquote

***

Annexure-VIII-A

Base rates of some of the Indian Banks- Historic illustrative data

<u>NATIONALISED-PSU BANKS</u>

ANDHRA BANK

Date	Base Rate
01-May-12	10.50%
01-Aug-11	10.75%
11-Jul-11	10.25%
09-May-11	10.00%
05-Feb-11	09.50%
13-Dec-10	09.00%
05-Oct-10	08.50%
01-Jul-10	08.25%

ALLAHABAD BANK

Date	Base Rate
01-May-12	10.50%
01-Aug-11	10.75%
15-Jul-11	10.25%
06-May-11	10.00%
01-Feb-11	09.50%
14-Dec-10	09.00%
01-Oct-10	08.50%
01-Jul-10	08.00%

BANK OF BARODA

Date	Base Rate
01-May-12	10.50%
01-Aug-11	10.75%
12-Jul-11	10.25%
06-May-11	10.00%
04-Feb-11	09.50%
13-Dec-10	09.00%
05-Oct-10	08.50%
01-Jul-10	08.00%

BANK OF INDIA

Date	Base Rate
01-May-12	10.50%
28-Jul-11	10.75%
05-May-11	10.00%
03-Feb-11	09.50%
15-Dec-10	09.00%
11-Oct-10	08.50%
01-Jul-10	08.00%

BANK OF MAHARASHTRA

Date	Base Rate

CANARA BANK

Date	Base Rate

Date	Base Rate
01-May-12	10.50%
21-Feb-12	10.60%
01-Oct-11	10.70%
02-Aug-11	10.50%
16-Jul-11	10.25%
05-May-11	10.00%
10-Jan-11	09.50%
15-Dec-10	09.00%
01-Jul-10	08.25%

Date	Base Rate
01-May-12	10.50%
01-Aug-11	10.75%
01-Jul-11	10.25%
05-May-11	10.00%
04-Feb-11	09.50%
13-Dec-10	09.00%
01-Oct-10	08.50%
01-Jul-10	08.00%

CENTRAL BANK

Date	Base Rate
01-May-12	10.50%
01-Aug-11	10.75%
09-May-11	10.00%
05-Feb-11	09.50%
15-Dec-10	09.00%
20-Oct-10	08.50%
01-Jul-10	08.00%

INDIAN BANK

Date	Base Rate
01-May-12	10.50%
01-Aug-11	10.75%
13-Jul-11	10.25%
05-May-11	10.00%
01-Feb-11	09.50%
13-Dec-10	09.00%
01-Oct-10	08.50%
01-Jul-10	08.00%

INDIAN OVERSEAS BANK

Date	Base Rate
01-May-12	10.50%
01-Aug-11	10.75%
01-Jul-11	10.25%
06-May-11	10.00%
01-Feb-11	09.50%
13-Dec-10	09.00%
01-Oct-10	08.50%
01-Jul-10	08.25%

IDBI BANK

Date	Base Rate
20-Apr-12	10.50%
01-Aug-11	10.75%
05-May-11	10.00%
08-Feb-11	09.50%
01-Jan-11	09.00%
01-Oct-10	08.50%
01-Jul-10	08.00%

PUNJAB NATIONAL BANK

Date	Base Rate

STATE BANK OF INDIA

Date	Base Rate

01-May-12	10.50%
01-Aug-11	10.75%
05-May-11	10.00%
01-Feb-11	09.50%
13-Dec-10	09.00%
01-Oct-10	08.50%
01-Jul-10	08.00%

13-Aug-11	10.00%
11-Jul-11	09.50%
12-May-11	09.25%
25-Apr-11	08.50%
14-Feb-11	08.25%
03-Jan-11	08.00%
21-Oct-10	07.60%
01-Jul-10	07.50%

SYNDICATE BANK

Date	Base Rate
01-May-12	10.50%
01-Aug-11	10.75%
05-Jul-11	10.25%
06-May-11	10.00%
03-Feb-11	09.50%
15-Dec-10	09.00%
04-Oct-10	08.50%
01-Jul-10	08.25%

UCO BANK

Date	Base Rate
01-May-12	10.50%
01-Aug-11	10.75%
12-Jul-11	10.25%
05-May-11	10.00%
01-Feb-11	09.50%
15-Dec-10	09.00%
05-Oct-10	08.50%
01-Jul-10	08.00%

UNION BANK

Date	Base Rate
01-May-12	10.50%
26-Dec-11	10.65%
08-Aug-11	10.75%
11-Jul-11	10.25%
07-May-11	10.00%
04-Feb-11	09.50%
27-Dec-10	09.00%
18-Oct-10	08.50%
01-Jul-10	08.00%

VIJAYA BANK

Date	Base Rate
01-May-12	10.45%
01-Aug-11	10.65%
01-Jul-11	10.25%
06-May-11	10.00%
01-Feb-11	09.50%
14-Dec-10	09.00%
01-Oct-10	08.50%
01-Jul-10	08.25%

PRIVATE BANKS

AXIS BANK

Date	Base Rate
06-Aug-11	10.00%
05-Jul-11	09.75%
05-May-11	09.50%
01-Apr-11	09.00%
19-Feb-11	08.75%
16-Jan-11	08.25%
09-Dec-10	08.00%
01-Oct-10	07.75%
01-Jul-10	07.50%

FEDERAL BANK

Date	Base Rate
02-May-12	10.45%
05-Mar-12	10.65%
07-Nov-11	10.75%
10-Oct-11	10.50%
01-Aug-11	10.25%
20-Jun-11	09.97%
10-May-11	09.72%
04-Apr-11	09.25%
10-Feb-11	09.00%
01-Jan-11	08.50%
01-Oct-10	08.00%
01-Jul-10	07.75%

HDFC BANK

Date	Base Rate
30-Jun-12	09.80%
13-Aug-11	10.00%
12-Jul-11	09.50%
12-May-11	09.25%
14-Mar-11	08.70%
24-Feb-11	08.20%
01-Jan-11	07.75%
05-Oct-10	07.50%
01-Jul-10	07.25%

ICICI BANK

Date	Base Rate
23-Apr-12	09.75%
13-Aug-11	10.00%
04-Jul-11	09.50%
07-May-11	09.25%
24-Feb-11	08.75%
03-Jan-11	08.25%
06-Oct-10	07.75%
01-Jul-10	07.50%

ING VYSYA BANK

Date	Base Rate
01-Oct-11	10.45%

JAMMU & KASHMIR BANK

Date	Base Rate
01-Nov-11	10.50%

Date	Base Rate
01-Aug-11	10.20%
21-Jun-11	09.70%
08-May-11	09.45%
23-Mar-11	08.90%
11-Feb-11	08.50%
03-Jan-11	08.25%
11-Oct-10	07.75%
01-Jul-10	07.25%

Date	Base Rate
01-Aug-11	10.00%
01-Jul-11	09.75%
01-May-11	09.50%
01-Mar-11	09.00%
01-Jan-11	08.75%
01-Oct-10	08.50%
01-Jul-10	08.25%

KARNATAKA BANK

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Date	Base Rate
03-Aug-11	11.00%
04-Jul-11	10.50%
23-May-11	10.25%
14-Feb-11	09.75%
01-Nov-10	09.00%
01-Jul-10	08.75%

KARUR VYSYA BANK

================

Date	Base Rate
27-Nov-11	11.25%
01-Aug-11	11.00%
16-May-11	10.50%
07-Feb-11	10.00%
24-Dec-10	09.50%
04-Oct-10	09.00%
01-Jul-10	08.50%

LAKSHMI VILAS BANK

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Date	Base Rate
29-Nov-11	11.00%
01-Aug-11	10.90%
03-Jun-11	10.50%
09-May-11	10.00%
05-Feb-11	09.50%
01-Jan-11	09.25%
01-Jul-10	08.75%

SOUTH INDIAN BANK

=================

Date	Base Rate
01-Aug-11	10.50%
04-Jul-11	10.00%
07-May-11	09.60%
05-Mar-11	09.10%
24-Jan-11	08.80%
20-Dec-10	08.50%
27-Oct-10	08.30%
01-Jul-10	08.10%

TAMILNAD MERCANTILE BANK

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Date	Base Rate

YES BANK

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Date	Base Rate

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01-Apr-12	11.00%	25-Oct-11	10.50%
12-Sep-11	10.75%	26-Jul-11	10.25%
18-Jul-11	10.50%	21-Jun-11	09.75%
09-May-11	10.00%	04-May-11	09.50%
01-Jan-11	09.50%	02-Apr-11	09.00%
01-Oct-10	09.00%	25-Jan-11	08.50%
01-Jul-10	08.50%	13-Dec-10	08.00%
		01-Jul-10	07.00%

SOURCE:http://in.reuters.com/article/2012/08/31/india-int-base-idINL4E8JV3RB20120831

Annexure-VIII-B

Base rates of some of the foreign Banks operating in India: Historic Illustrative data

ABU DHABI BANK ============== Date Base Rate ---------- --------- 12-Aug-11 10.00% 01-Jul-11 09.50% 01-Apr-11 09.00% 01-Jan-11 08.25% 01-Jul-10 07.50%	BARCLAYS BANK ============= Date Base Rate ---------- --------- 01-Jun-12 10.25% 01-Nov-11 10.50% 01-Oct-11 10.25% 01-Jul-11 10.00% 01-Mar-11 09.50% 01-Jan-11 09.00% 01-Dec-10 08.50% 01-Nov-10 08.00% 01-Oct-10 07.50% 01-Jul-10 07.00%
BANK OF TOKYO ============= Date Base Rate ---------- --------- 09-Jul-12 07.25% 04-Apr-12 07.80% 02-Jan-12 07.40% 01-Sep-11 07.00% 12-May-11 07.10% 03-Feb-11 06.70% 29-Dec-10 06.50% 28-Sep-10 06.25% 28-Jul-10 06.00% 01-Jul-10 05.50%	BANK OF AMERICA =============== Date Base Rate ---------- --------- 29-Jun-12 09.75% 26-Dec-11 10.00% 05-Aug-11 09.50% 10-May-11 09.00% 29-Mar-11 08.50% 04-Feb-11 08.00% 29-Nov-10 07.50% 04-Oct-10 07.25% 01-Jul-10 06.75%
BNP PARIBAS ============ Date Base Rate	CITIBANK ============ Date Base Rate

<table>
<tr><td>---------- ---------
10-Oct-11 09.50%
08-Aug-11 09.25%
16-May-11 08.75%
25-Apr-11 08.25%
01-Feb-11 07.50%
01-Nov-10 07.25%
01-Jul-10 06.75%</td><td>---------- ---------
05-Aug-11 09.75%
27-Jun-11 09.50%
09-May-11 09.00%
25-Feb-11 08.50%
22-Dec-10 08.00%
01-Oct-10 07.75%
01-Jul-10 07.25%</td></tr>
<tr><td>DEVELOPMENT BANK OF SINGAPORE
==============================
Date Base Rate
---------- ---------
01-Jun-12 09.75%
01-Mar-12 10.00%
21-Nov-11 09.50%
01-Nov-11 09.25%
01-Sep-11 09.00%
01-Jul-11 08.75%
02-May-11 08.50%
01-Mar-11 08.25%
01-Jan-11 08.00%
20-Oct-10 07.25%
01-Jul-10 07.00%</td><td>DEUTSCHE BANK
=============
Date Base Rate
---------- ---------
24-Apr-12 10.00%
02-Mar-12 10.50%
02-Nov-11 10.00%
02-Sep-11 09.75%
02-Aug-11 09.50%
24-Jun-11 09.25%
04-May-11 08.75%
16-Mar-11 08.25%
07-Jan-11 07.75%
03-Nov-10 07.25%
01-Jul-10 06.75%</td></tr>
<tr><td>HSBC
====
Date Base Rate
---------- ---------
02-Aug-11 09.75%
04-Jul-11 09.25%
12-May-11 09.00%
09-Mar-11 08.50%
04-Jan-11 08.00%
01-Oct-10' 07.50%
01-Jul-10 07.00%</td><td>ROYAL BANK OF SCOTLAND
======================
Date Base Rate
---------- ---------
13-Aug-12 09.75%
07-Oct-11 10.00%
05-Aug-11 09.75%
12-May-11 09.00%
09-Mar-11 08.50%
24-Dec-10 07.75%
01-Oct-10 07.00%
01-Jul-10 06.50%</td></tr>
<tr><td>STATE BANK OF MAURITIUS</td><td>SOCIETE GENERAL</td></tr>
</table>

======================== Date Base Rate	=============== Date Base Rate
24-Feb-12 11.00%	01-Aug-12 09.85%
02-Jan-12 10.75%	21-Jun-12 10.00%
03-Aug-11 10.00%	21-May-12 10.35%
12-May-11 09.25%	02-Apr-12 10.95%
01-Mar-11 08.25%	02-Jan-12 10.40%
01-Nov-10 07.75%	28-Sep-11 10.20%
01-Jul-10 07.50%	01-Aug-11 09.75%
	22-Mar-11 09.30%
	15-Feb-11 09.10%
	17-Jan-11 08.60%
	15-Dec-10 08.40%
	15-Nov-10 08.25%
	01-Jul-10 07.50%

STANDARD CHARTERED BANK

Date	Base Rate
01-Sep-11	09.75%
22-Jul-11	09.50%
20-May-11	09.25%
21-Feb-11	08.50%
21-Dec-10	08.00%
01-Oct-10	07.50%
01-Jul-10	07.25%

SOURCE:http://in.reuters.com/article/2012/08/31/india-int-base-idINL4E8JV3RB20120831

Annexure –IX-A

Credit Rating yields

21st January, 2011

Addl. Commissioner of Income Tax (Transfer Pricing) - 1(3)
Room No. 303 Drum Shaped Building,
I P Estate,
New Delhi

Sir,

Re: Crisil Ltd. (PAN- AAACT3151E)
Sub: Information u/s 133(6) of the Act

We have received letter F.No.ADDL. CIT/TPO1(3)/2010-11/362 dated 17/01/2011 on 18/01/2011 asking us to furnish certain information. In this regards we submit the available information as under:

Annualised Average Yield					Annualised Average Yield			
	2007-2008					2008-2009		
Ratings	1-2 Yr	2-3 Yr	5 yr		Ratings	1-2 Yr	2-3 Yr	5 yr
AAA	9.32%	9.38%	9.44%		AAA	9.98%	10.02%	10.05%
AA+	9.56%	9.66%	9.73%		AA+	10.28%	10.34%	10.38%
AA-	10.10%	10.12%	10.21%		AA-	10.83%	10.81%	10.87%
AA	9.71%	9.81%	9.88%		AA	10.42%	10.51%	10.55%
BBB+	13.04%	13.24%	13.31%		BBB+	13.27%	13.42%	13.47%
BBB-	15.68%	15.83%	15.89%		BBB-	15.41%	15.52%	15.55%
BBB	14.18%	14.33%	14.39%		BBB	14.21%	14.32%	14.35%
A+	10.68%	10.68%	10.77%		A+	11.41%	11.37%	11.43%
A-	12.22%	12.37%	12.42%		A-	12.95%	13.05%	13.08%
A	11.24%	11.29%	11.42%		A	11.96%	11.97%	12.08%

Note:A simple average of the yields for the whole financial year has been taken to arrive at the yields in the table above for the respective ratings

We hope above meets your requirement

Thanking you,

Yours faithfully,

For **Crisil Ltd.**

(Pramendra Mehta)
Manager Taxation

Annexure- IX-B

Note on Credit Ratings by CRISIL, ICRA, FITCH, and CARE:-

The credit rating agencies registered with SEBI are CARE, CRISIL, FITCH India and ICRA (Moody's). SEBI has, vide its circular CIR/MIRSD/4/2011 dated June 15, 2011 on 'Standardisation of Rating Symbols and Definitions', instructed Credit Rating Agencies (CRAs) registered with SEBI to adopt common rating symbols and rating definitions, which shall henceforth be used for the new ratings / reviews by the CRAs.

The new symbols and definitions as given in Annexures 1-6 of the above Circular shall henceforth (30-10-2011) be used for the new ratings/ reviews by the CRAs.

In pursuance of the above Circular, all the credit rating agencies, registered with SEBI, have revised their Rating Symbols and their Definitions, which shall henceforth be used for the ratings assigned by the Company. Under the revised standardized system, there is no change in the long term rating symbols except that rating symbols will henceforth display the rating agency's name as a prefix. Thus the rating methodology and ratings almost match on scales This can be known from the following examples of unrelated entities, which are rated by multiple agencies during the same period of time for long-term loans / debt.

Si No	Name of the Company	Rating given by CRISIL	Rating given by ICRA	Rating given by FITCH	Rating given by CARE
1	Videocon Industries Ltd			**A-**	**A-**
2	ACC Ltd	**AAA**		**AAA**	
3	Aditya Birla Nuvo Ltd		**AA+**		**AA+**

Basis of Credit ratings by CRISIL

In India, CRISIL & ICRA are the leading credit rating agencies. In fact CRISIL is India's leading rating agency, with over a 70% share of the Indian ratings market and is the fourth largest in the world., CRISIL Ratings offer a comprehensive range of rating services..

Most importantly, CRISIL is the only rating agency at present to operate on the basis of sectoral specialization, list of sectors tracked by CRISIL ratings isas follows.

- Materials
- Industrials
- Energy
- Consumer Discretionary
- Consumer Staples
- Health care
- Utilities
- Information Technology
- Telecommunication Servies
- Financials
- Structured Finance
- Funds
- Governance and Value creation
- Maritime Grading
- Microfinance Institutions Grading
- Small and Medium Enterprises

CIRCULAR

CIR/MIRSD/4/2011 June 15, 2011

All Credit Rating Agencies Registered with SEBI

Dear Sirs,

Sub: Standardisation of Rating Symbols and Definitions

1. It has been observed that the Credit Rating Agencies (CRAs) registered with SEBI use different rating symbols and definitions.

2. It has been felt that there need to be common rating symbols and definitions (i) for easy understanding of the rating symbols and their meanings by the investors, and (ii) to achieve high standards of integrity and fairness in ratings.

3. The issue was discussed in the meeting of Corporate Bonds and Securitisation Advisory Committee of SEBI. The Committee recommended that the rating symbols and their definitions should be standardised.

4. Pursuant to the above, in consultation with the CRAs and considering the international practices, standardised symbols and their definitions have been devised for the following:

    a) Long term debt instruments;
    b) Short term debt instruments;
    c) Long term structured finance instruments;
    d) Short term structured finance instruments;
    e) Long term mutual fund schemes; and
    f) Short term mutual fund schemes.

5. The new symbols and definitions as given in Annexures 1-6 shall henceforth be used for the new ratings/ reviews by the CRAs.

6. For existing outstanding ratings, the CRAs shall:
    (i) disclose new rating symbols and definitions on their websites;
    (ii) update their rating lists on their websites; and
    (iii) inform their clients about the change in the rating symbols and definitions and specifying that this should not be construed as a change in the ratings.

7. The CRAs shall ensure compliance with the requirements specified at Clause 6 above, as early as possible but not later than 4 months from the date of issuance of this circular.

8. The CRAs shall communicate to SEBI, the status of the implementation of the provisions of this circular by October 31, 2011. They shall also place the compliance status of this circular before their Boards.

9. This circular is issued in exercise of the powers conferred by Section 11 (1) of Securities and Exchange Board of India Act, 1992 read with the provisions of regulations 13, 18 and 20 of SEBI (Credit Rating Agencies) Regulations, 1999 to protect the interest of investors in securities and to promote the development of, and to regulate, the securities market.

Yours faithfully,

Prasanta Mahapatra
Deputy General Manager
Tel. No: 022-26449313
Email id : prasantam@sebi.gov.in

Encl: as above

ANNEXURE 1

I. Rating Symbols and Definitions for Long Term Debt Instruments

Long term debt instruments: The instruments with original maturity exceeding one year

Rating symbols should have CRA's first name as prefix

AAA - Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.

AA - Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.

A - Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.

BBB - Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.

BB - Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.

B - Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

C - Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.

D - Instruments with this rating are in default or are expected to be in default soon.

Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories AA to C. **The modifiers reflect the comparative standing within the category.**

ANNEXURE 2

II. Rating Symbols and Definitions for Short Term Debt instruments

Short term debt instruments: The instruments with original maturity of upto one year

Rating symbols should have CRA's first name as prefix

A1 – Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations. Such instruments carry lowest credit risk.

A2 - Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations. Such instruments carry low credit risk.

A3 - Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligations. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.

A4- Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations. Such instruments carry very high credit risk and are susceptible to default.

D - Instruments with this rating are in default or expected to be in default on maturity.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1 to A4. **The modifier reflects the comparative standing within the category.**

ANNEXURE 3

III. Rating Symbols and Definitions for Long Term Structured Finance *Instruments*

Long term **structured finance** *instruments: The instruments with original maturity exceeding one year*

Rating symbols should have CRA's first name as prefix

AAA (SO) - Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.

AA (SO) - Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.

A (SO) - Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.

BBB (SO) - Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.

BB(SO) - Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.

B(SO) - Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

C (SO) - Instruments with this rating are considered to have very high likelihood of default regarding timely payment of financial obligations.

D (SO) - Instruments with this rating are in default or are expected to be in default soon.

***Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories AA(SO) to C(SO).* The modifiers reflect the comparative standing within the category.**

ANNEXURE 4

IV. Rating Symbols and Definitions for Short Term Structured Finance Instruments

Short term **structured finance instruments**: ***The instruments with original maturity of upto one year***

Rating symbols should have CRA's first name as prefix

A1 (SO) – Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligation. Such instruments carry lowest credit risk.

A2 (SO) - Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligation. Such instruments carry low credit risk.

A3 (SO) - Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligation. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.

A4 (SO) - Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligation. Such instruments carry very high credit risk and are susceptible to default.

D (SO) - Instruments with this rating are in default or expected to be in default on maturity.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1(SO) to A4(SO). **The modifier reflects the comparative standing within the category.**

ANNEXURE 5

V. **Rating Symbols and Definitions for Long Term Debt Mutual Fund Schemes**

Long term debt mutual fund schemes: The debt mutual fund schemes that have an original maturity exceeding one year.

Rating symbols should have CRA's first name as prefix

AAAmfs – Schemes with this rating are considered to have the highest degree of safety regarding timely receipt of payments from the investments that they have made.

AAmfs – Schemes with this rating are considered to have the high degree of safety regarding timely receipt of payments from the investments that they have made.

Amfs – Schemes with this rating are considered to have the adequate degree of safety regarding timely receipt of payments from the investments that they have made.

BBBmfs - Schemes with this rating are considered to have the moderate degree of safety regarding timely receipt of payments from the investments that they have made.

BBmfs - Schemes with this rating are considered to have moderate risk of default regarding timely receipt of payments from the investments that they have made.

Bmfs - Schemes with this rating are considered to have high risk of default regarding timely receipt of timely receipt of payments from the investments that they have made.

Cmfs - Schemes with this rating are considered to have very high risk of default regarding timely receipt of timely receipt of payments from the investments that they have made.

***Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories AAmfs to Cmfs.* The modifiers reflect the comparative standing within the category.**

ANNEXURE 6

VI Rating Symbols and Definitions for Short Term Debt Mutual Fund Schemes

Short term debt mutual fund schemes: The debt mutual fund schemes that have an original maturity of upto one year.

Rating symbols should have CRA's first name as prefix

A1mfs - Schemes with this rating are considered to have very strong degree of safety regarding timely receipt of payments from the investments that they have made.

A2mfs - Schemes with this rating are considered to have strong degree of safety regarding timely receipt of payments from the investments that they have made.

A3mfs - Schemes with this rating are considered to have moderate degree of safety regarding timely receipt of payments from the investments that they have made.

A4mfs - Schemes with this rating are considered to have minimal degree of safety regarding timely receipt of payments from the investments that they have made.

***Modifier {"+" (plus)} can be used with the rating symbols for the categories A1mfs to A4mfs.* The modifier reflects the comparative standing within the category.**

Annexure XII-A

S.NO.	Name of the Bank	Bank Guarantee Charges for FY 2008-09	
		Remarks	
		Financial Guarantee	Financial Guarantee charges per annum
1	Axis Bank	2.50 % p.a. (Minimum Rs. 500/-)	2.50 %
2	Canara Bank	Base rate of Rs. 120+3.60% p.a. or part of there of no. maximum ceiling	3.60
3	Punjab National Bank	Rs. 100+3.6% p.a. or part there of with minimum of 1.8%	3.6
4	ICICI Bank *	1. For AAA rated customers (1.8% p.a.) 2. For AA rated customers (2.1% p.a.) 3. For A rated customers (2.4% p.a.) (minimum of Rs. 1000/-)	*2.4
5	Bank of Baroda	0.83% per quarter	3.32
6	HDFC Bank	1.8% p.a.	1.80
7	SBI Bank **	1. Upto Rs. 5 Cr. -2.75 p.a. 2. Portion above Rs. 5 Cr. and upto Rs. 10 Cr. – 2.25% p.a. 3. Portion above Rs.10 cr -1.75% p.a.	# 2.75
		Total	19.95
		Arithmetic mean	2.85%

(*) The rate to be taken by the TPO depends on the credit rating of the associate enterprise. In all probability, the associated enterprise is not likely to have rating beyond 'A' else there would not have been only need for the corporate guarantee by the parent company.

(#) The rate is taken by TPO on the 'Amount' of corporate guarantee extended by the assessee to its associated enterprises.

Annexure-XII-B

S.NO.	Name of the Bank	Bank Guarantee Charges for FY 2012-13	
		Remarks	
		Financial Guarantee	**Financial Guarantee charges per annum**
1	Axis Bank	1.75 % p.a. (Minimum Rs. 1000/-)	1.75 %
2	Canara Bank	Minimum Rs. 1000+0.3 % p.m. or part there of no maximum ceiling	3.60
3	Punjab National Bank	Rs. 100+09% per quarter or part there of with minimum of 1.8%	3.60
4	ICICI Bank *	1. For AAA rated customers (1.8% p.a.) 2. For AA rated customers (2.1% p.a.) 3. For A rated customers (2.4% p.a.) (minimum of Rs. 1000/-) FY 2008-09	Current year charges not provided
5	Bank of Baroda	0.25% p.m. + Service tax	3.0% + services tax
6	HDFC Bank	Minimum Rs. 1000+ 1.8% p.a	1.80
7	SBI Bank **	1. Upto Rs. 5 Cr. -2.10 p.a.	2.1%
		2. Portion above Rs. 5 Cr. and upto Rs. 10 Cr. – 1.60% p.a.	1.6%
		3. Portion above Rs. 10 Cr/ = 1.30 p.a.	1.3%

* The rate to be taken by TPO depending upon the credit rating of the associated enterprise. most likely, the associated enterprise is not likely to have rating beyond 'A' else there would not have been the need of corporate guarantee..

** The rate is taken by TPO on the amount of corporate guarantee extended by the assessee to its associated enterprise.

Annexure-XIII

Decisions on Corporate Guarantee

1. Decision of DRP-II. Mumbai

Briefly stated, the assessee, as the parent company, had the prime responsibility to arrange funds for the SPV XYZ minerals for the acquisition of an overseas entity viz K. Consequently, the assessee provided a Corporate Guarantee to the international Banks with reference to loan facility agreement dated 10 May 2007 entered into by XYZ Minerals and the assessee with these Banks for availing the bridge loan for the acquisition of K.

- The assessee did not charge any guarantee fee to XYZ Minerals on the ground that the loan was drawn by the AE only to facilitate the assessee's acquisition of K and hence the guarantee was for the benefit of the assessee itself.
- The TPO however, held this to be an international transaction and relied on decisions of the Tax Court of Canada in the case of General Electric Capital Canada, and of the Tax Court of USA in the case of Container Corporation, to hold that even in such a situation where the holding company provides a guarantee for the benefit of a subsidiary, an arm's length guarantee fee is required to be computed. The TPO using the decision of Tax Court of Canada in G E Capital, held that in this case the average yields on corporate loans would provide an adequate base for valuing the guarantee fee chargeable in this case. He held that XYZ Minerals was only a shell company set up to facilitate the takeover of K, and hence assigned a default credit rating of D. A credit rating of AA was assigned to assessee and the TPO relied upon the information obtained from a domestic rating agency to hold that the average yields on 5 year unsecured corporate bonds would be 20.41% for companies with credit rating BB and 9.71% for the companies with credit rating AA. The difference of 10.7% was held to be guarantee fee chargeable by assessee, and considering the outstanding guarantee

amount of Rs.12170 crores and the number of days for which the same was outstanding during the year, he computed the amount of guarantee fee at Rs.1156 crores at the rate of 10.76 %.

- The DRP –II Mumbai considered decision dated 6th June, 2012 of the ITAT, Mumbai Bench, in ITA Nos. 8597/Mum/2010 and 7999/Mum/2011 in the case of Mahindra & Mahindra Ltd., where it was held in event of the parent providing a corporate guarantee for the benefit of its subsidiary, a guarantee fee of 3 % would represent an arm's length price.
- DRP held that since transfer pricing analysis seeks to determine the price that would be charged in an uncontrolled transaction between unrelated parties in comparable circumstances, the contention that the guarantee was for assessee's own benefit and not for the benefit of the AE, was not relevant.
- DRP accepted that the average annualised yields specified by a rating agency in respect of short term and medium term corporate bonds could, in certain circumstances, provide a base for making a reasonable estimate of the amount of risk assumed by a company providing a corporate guarantee. But it also cautioned that making assumptions regarding such ratings can seriously distort the estimation of risk assumed.
- DRP analysed the case of GE Canada, where the credit ratings of the concerned parties assigned by professional agencies were not disputed but held that the decision of Tax Court of Canada in that case cannot be applied as such in the case of the assessee for determining the quantum of guarantee fee.
- DRP also agreed with the assessee that since the relevant loan has been taken overseas in foreign currency, and the lender and the borrower are both overseas, it is not appropriate to use domestic corporate bond interest rates to bench mark the guarantee fees.

- DRP held that though the TPO was justified in attempting to establish an arm's length price in respect of the guarantee provided by the assessee, and though the approach taken by him could in principle be justified, the actual analysis carried out cannot be accepted as providing a reliable measure of the said arm's length price. **But accepted that there is a question of sharing or splitting an interest differential that must be considered.**
- DRP was of the view that the above amount would represent only the basic cost of the guarantee provided by the assessee. In accordance with the principles of transfer pricing, a reasonable mark-up has to be added to this cost considering the nature of benefit. Foreign exchange risk and the foreign exchange fluctuation risk borne by the assessee in providing the corporate guarantee, needed to be considered.
- Taking into account all the factors, DRP held that a fee of 2.5 % or 250 bps would represent the arm's length amount of guarantee fee that should have been charged by the assessee in this transaction.

2. M/s Everest Kanto Cylinder Ltd

In another recent case the INCOME TAX APPELLATE TRIBUNAL "K", BENCH MUMBAI in ITA No.542/Mum/2012 for Assessment Year :2007-2008, in the case of M/s Everest Kanto Cylinder Ltd. in order dated 23rd Nov 2012 in para 19 of its order held that ,

Quote

The charging of a guarantee commission depends upon transaction to transaction and mutual understanding between the parties. There may be a case where the bank may not charge any guarantee commission, depending upon its evaluation of relationship with a particular client. Even otherwise also the TPO himself has noted that guarantee commission ranges between0.15% to 3% in case of HSBC. The universal application of rate of 3%for guarantee commission cannot be upheld in every case as it is largely dependent upon the terms and conditions, on which loan has been given, risk undertaken,

relationship between the bank and the client, economic and business interest are some of the major factors which has to be taken into consideration. In the present case, when the assessee has specifically stated that neither it has incurred any cost for providing the guarantee to the bank for loan taken by its subsidiary nor has undertaken any kind of risk, as it was the subsidiary company which has hypothecated its assets against the loan, the TPO has not brought anything on the record to controvert the same. He has proceeded on the premise that there is always a risk in providing the guarantee and some kind of security is needed for giving a guarantee. Such a premise of the Assessing Officer is without basis or material on record. Thus, applying the rate of 3% on the guarantee commission based on external comparables and that to be on naked quote given in the website, is uncalled for in the present case. So far as the learned Senior Counsel's contention that guarantee commission is not an international transaction and there could not be any method for evaluating the ALP for the guarantee commission, we do not find any merit in the said contention in view of the amendment brought by the Finance Act, 2012 with retrospective effect from 1-4-2002 by way of Explanation added in Section 92B. Payment of guarantee fee is included in the expression 'international transaction' in view of the Explanation i(c) of Section 92B. Once the guarantee fee falls within the meaning of 'international transaction', then the methodology provided in the rules also becomes applicable. Here in this case, it is undisputed that the assessee in its T.P. Study Report and also the TPO, have accepted that it is an international transaction and CUP is the most appropriate method for benchmarking the charging of guarantee fee. We also do not agree with the contention of the learned counsel that there could not be any cost or charge of guarantee fee by providing corporate guarantee to its subsidiary because there is an always element of benefit or cost while providing such kind of guarantee to AE.

Unquote

The adjustment made by the TPO was deleted by the ITAT

Annexure-XIV

Observations of a stakeholder

Quote

Determination of a guarantee fee commences with analysis of the fact whether the provision of guarantee is in the nature of shareholder function or rendering of services. For analyzing the same, one needs to consider the following factors :

- *Whether the borrowing entity has the creditworthiness to borrow the loan in absence of the guarantee ?*
- *What is the purpose for which the loan has been obtained ?*
- *Which entity has undertaken the business decision to borrow the loan ?*
- *If the loan has been taken for acquisition of an entity, the business/ commercial rationale for the acquisition ?*
- *What is the source of funds for servicing the interest on the loan and also repayment of the loan ?*
- *Analysis of the above factors would determine whether or not the provision of guarantee is a service provided by the guarantor. In case where provision of guarantee is not a shareholder function; and a guarantee fee is applicable, one further needs to analyze the following aspects :*
    - *The type of guarantee – financial or performance;*
    - *Nature of guarantee – implicit (no actual guarantee fee is payable) or explicit (guarantee fee is payable);*
    - *Whether the guarantee provision was a primary condition for the loan or is merely a result of belt and braces approach?*

Further, given the complexities around the issue of guarantees, PwC India strongly recommends that no Safe Harbour may be introduced with respect to transactions of guarantees.

Unquote

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Fourth Report of the Committee to Review Taxation of Development Centres and the IT sector

(Safe Harbour for Contract R & D in the IT Sector)

5th April, 2013

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The Prime Minister had constituted this Committee to Review Taxation of Development Centres and the IT Sector and to recommend Safe Harbour provisions for taxpayers doing business in certain sectors. The Committee has already submitted three reports to the Government and is glad to furnish its fourth report now. This report is the third on Safe Harbour provisions. The first report, submitted on 14th September, 2012, had addressed the taxation issues confronting the IT Sector and the Development Centres. The second report (first on Safe Harbour provisions), submitted on 13th October, 2012, had laid down the recommendations for Safe Harbour provisions for the IT-Software and ITES sectors. The third report, submitted on 18th December, 2012, had recommended Safe Harbour provisions for two areas of the financial sector, i.e., Outbound Loans and Corporate Guarantees.

This report, the fourth, contains the Committee's recommendations for Safe Harbour provisions in respect of Contract R&D in the IT Services Sector. Two more reports on Safe Harbour provisions for Contract R&D in the Pharmaceutical Sector and for Auto Ancilliaries [Original Equipment Manufacturers], respectively, would be submitted by the Committee in this month itself.

While furnishing this report, I must duly acknowledge the outstanding contributions made by its members, namely, Ms. Anita Kapur, Member (A&J), CBDT, Ms. Rashmi Saxena Sahni, DIT (Transfer Pricing-I), Delhi and Mr. Dinesh Kanabar, Tax Expert, in examining the issues and finalizing the Committee's approach. All of them have displayed an amazing degree of commitment and conviction. Their invaluable inputs have enabled the Committee to finalise its recommendations.

I would also like to appreciate the sincere efforts put in by the three senior officers of the Department, namely Shri Subhakant Sahu, Shri D. Prabhakar Reddy and Shri Sobhan Kar, Addl. Commissioners of Income-tax, to assist the Committee in its deliberations and finalization of its recommendations.

Lastly, I would like to place on record the Committee's appreciation of the efforts put in by the staff of the Member (A&J), CBDT in providing logistical assistance to the Committee in finalizing this report.

N. Rangachary,
Chairman
5th, April, 2013

Fourth Report of the Committee

to Review Taxation of Development Centres and the IT Sector

(Safe Harbour for Contract R&D in the IT Sector)

Submitted by

Anita Kapur

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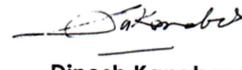

Dinesh Kanabar

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[Former Chairman, CBDT &IRDA]

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PART-1: INTRODUCTION

1.1 Prime Minister's Office issued a press release on July 30, 2012 **(Annexure-I),** stating that the Hon'ble Prime Minister had constituted a Committee to Review Taxation of Development Centres and the IT Sector under the Chairmanship of Shri N. Rangachary, former Chairman CBDT & IRDA. The Committee submitted its first report to the Government on 14th September, 2012 covering issues listed in the terms of reference of the Committee, except the following:

"Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector."

1.2 The rationale for entrusting the Committee with the task of finalising Safe Harbour rules was explained in the Press Release (ibid) as follows:

"As far as Safe Harbour provisions are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer"

1.3 The Committee was advised to suggest Safe Harbour Rules individually, sector-by-sector, in a staggered manner.

1.4 Vide Office Memorandum dated 13th September, 2012 (**Annexure-II**), the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors / activities:

(a) IT Sector

(b) ITES Sector

(c) Contract R&D in the IT and Pharmaceutical Sector

(d) Financial Transactions – Outbound loans

(e) Financial Transactions – Corporate Guarantee
(f) Auto Ancillaries – Original Equipment Manufacturers

1.5 The Committee submitted its second report, the first on Safe Harbours, on 13th October, 2012 to the Government. That report contained its recommendations for Safe Harbour rules for IT and ITES sectors.

1.6 The Committee's third report, which made recommendations for Safe Harbour rules for financial transactions of outbound loans and corporate guarantees, was submitted on 18th December, 2012.

1.7 This report, the Committee's fourth, contains Safe Harbour recommendations on Contract R&D in the IT Sector but not in the Pharmaceutical Sector. As there is an organic linkage between this report on Contract R&D in the IT Sector and the earlier one on Safe Harbours for IT and ITES sectors, it is being submitted separately. The reports for the remaining 2 sectors, namely, contract R&D in Pharmaceutical Sector and Auto Ancillaries – Original Equipment Manufacturers, would be submitted shortly.

***

PART-2: DELIBERATIONS IN THE COMMITTEE

2.1 Part 2 of the first report of the Committee on Safe Harbours (second report of the Committee) for the IT (Software) & ITES sectors included a detailed analysis of the statutory provisions regarding Safe Harbours [Section 92CB of the Income-tax Act], the need for having Safe Harbours and the opposition to the same, types of Safe Harbours, cross country transfer pricing simplification measures, and existing transfer pricing simplification measures in India.

2.2 Since those concerns, analyses and explanations, in the view of the Committee, are equally relevant for this report, reference is invited to the said portion of the first report on Safe Harbours. **However, no detailed discussion on these issues is being incorporated here to avoid repetition.**

2.3 Suggestions and data to frame Safe Harbour provisions for contract R&D in the IT Sector were invited from the following stakeholders:

- Central Board of Direct Taxes;
- NASSCOM (National Association of Software and Service Companies)
- CII (Confederation of Indian Industry)
- FICCI (Federation of Indian Chambers of Commerce and Industry)
- ASSOCHAM (Associated Chambers of Commerce and Industry of India)
- PHDCCI (PHD Chamber of Commerce & Industry)
- ICAI (Institute of Chartered Accountants of India)
- PWC (Price Waterhouse Coopers)
- E&Y (Ernst & Young)
- Deloitte Haskins & Sells
- KPMG
- BMR Advisors

- Vaish & Associates, Delhi
- T. P. Ostwal & Associates, Mumbai

2.4 Discussions were also held by the Committee members with Shri Ajay Choudhary, [1] founder HCL Technologies, to understand the business model generally prevalent in this sector i.e., contract R&D in IT. Shri Choudhary explained how concurrent engineering for the product is done by the industry. According to him, -

- The concept of Concurrent Engineering is of significant importance in respect of contract R&D.
- Concurrent Engineering generally refers to the process through which an R&D work to be outsourced is determined.
- All the Divisions of the parent company [other than the R&D Division] like Sales, Engineering or Manufacturing interact extensively with each other and then give inputs of their own Division to the R&D Division.
- This helps the R&D Division to arrive at an agreed upon specification of the R&D to be done.
- This specification is dependent upon the product or process (output) that is envisioned as a result of the R&D. This whole process is known as Concurrent Engineering.
- Thereafter, the parent company takes a call to outsource the various modules of the R&D work to any of its captive R&D centres in the world. The final product is the result of the integration of all the R&D modules.
- Concurrent Engineering demonstrates that the decision on the R&D to be done is taken at the level of the parent company.

2.5 To facilitate the Safe Harbour analysis for Contract R&D in the IT Sector, the Central Board of Direct Taxes (CBDT) and industry stakeholders were asked

[1] He can be contacted at email id: akcd_29@yahoo.co.in. His office telephone no. is 0120-2544522

to provide their comments and data. Data was called for in respect of the value of international transactions; the margins shown by the assessee; and the margins adopted by the Transfer Pricing Officers (TPOs) across the country for Assessment Years 2006-07, 2007-08 and 2008-09. In addition, the Income Tax Department was requested to furnish data for A.Y 2009-10 too, as Transfer Pricing audit for the said assessment year concluded recently in January, 2013.

***

PART-3: SAFE HARBOUR FOR CONTRACT R & D IN INFORMATION TECHNOLOGY SECTOR

3.1 The Economic Survey 2012-13[2] acknowledges that, *"the IT-ITES industry has four major sub-components: IT services, Business Process Outsourcing (BPO), Engineering Services and R&D, and software products."* This report provides recommendations on Safe Harbour for contract R&D in the IT Sector.

3.2 But what is Research and Development (R&D)? R&D is defined by Cambridge's Advanced Learner's Dictionary as *"the part of a business that tries to find ways to improve existing products and to develop new ones"*[3].

3.2.1 The UNCTAD's Investment Report – 2005 defines R&D as follows:

"R&D is only one component of innovation activities, but it represents the most developed, widely available, and internationally comparable statistical indicator of industrial innovation activities."

3.2.1.1 The report refers to an OECD study and states that R&D (also called research and experimental development) comprises creative work "undertaken on a systematic basis in order to increase the stock of knowledge, including knowledge of man, culture and society, and the use of this stock of knowledge to devise new applications (OECD 2002b, p. 30).

3.2.1.2 The report goes on to say that R&D involves novelty and the resolution of scientific and technological uncertainty. It includes basic and applied research along with development (United States, NSB 2004):

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[2] Paragraph 10.42, page 223 of Economic Survey 2012-13, Ministry of Finance, Government of India

[3] Cambridge's Advanced Learner's Dictionary - http://dictionary.cambridge.org/dictionary/british/re-search-and-de-velopment

- **Basic research.** The objective of basic research is to gain a more comprehensive knowledge or understanding of the subject under study without specific applications in mind. In industry, basic research is defined as research that advances scientific knowledge but does not have specific immediate commercial objectives.
- **Applied research.** The objective of applied research is to gain the knowledge or understanding to meet a specific, recognized need. In industry, applied research includes investigations to discover new scientific knowledge that has specific commercial objectives with respect to products, processes, or services.
- **Development.** Development is the systematic use of the knowledge or understanding gained from research directed towards the production of useful materials, devices, systems or methods, including the design and development of prototypes and processes.

3.2.1.3 It further states that for data collection purposes, the boundary between R&D and other technological innovation activities can be found in pre-production development activities (OECD 2002b). In practice, however, it is difficult to make the distinction. In technology-intensive industries, distinguishing between "research" and "development" is especially difficult since much of the R&D work conducted involves close interaction between researchers in both the private and public sectors, often also including close collaboration with customers and suppliers (BIAC2005, Amsden and Tschang 2003).

3.2.2 As is well known, R&D off-shoring started in India in 1984 with Texas Instruments setting up its first R&D centre in Bangalore and there has been no looking back since then. The Committee has noted that there is a growing perception that India must have a place in the top league and paragraph

10.22 of the Economic Survey identifies R&D as an important service in the Indian economy. The survey[4] goes on to state further as follows:

Quote:

10.45 Among business services, R&D occupies the second position in India's GDP with growth being consistently high at near 20 per cent in the last few year with growth in 2011-12 at 20.5 per cent. Until recently, the competitive advantage in R&D was almost exclusively with the developed economies. Of late, emerging countries are increasingly involved in R&D and innovation, with active involvement of both public and private sectors. Factors such as low cost, access to new markets, availability of knowledge-oriented manpower, favorable regulatory environment, and fiscal benefits play a major role in driving R&D investments toward emerging economies. These countries are also encouraging innovation through legal, regulatory, and policy support.

10.46 The US $ 1.5 trillion global gross expenditure on R&D (GERD) for 2013 projected by Battelle and R&D magazine is expected to grow by more than US$ 50 billion over the previous year. In this enormous activity, India's share is 3 per cent with GERD in PPP (purchasing power parity) terms projected at US $ 45.2 billion which is around five times lower than that of China. As a percentage of GDP also it is low at 0.9 per cent. This is partly because the size of the R&D base and absorption capacity is not commensurate with requirements. As per the report, the share of basic research in India's R&D is estimated to be 26 per cent, applied research 36 per cent, development research 32 per cent, and other research 6 percent. Government funding of R&D accounts for two–thirds of the total

[4] Paragraphs 10.45 and 10.46, page no. 225 of Economic Survey 2012-13, Ministry of Finance, Government of India.

funding. Industry contribution to R&D has been steadily increasing over the years but is still less than third of the total. Government support for R&D in India tends to focus on classical objectives for public R&D funding such as nuclear energy, defence, space, health, and agriculture.

Unquote

3.2.3 Jose Guimon,[5] in his paper 'Global trends in R&D–intensive FDI and policy implications for developing countries', states as follows:

Quote:

R&D-intensive FDI was formerly a triadic rather than global phenomenon, with both inflows and outflows heavily concentrated in the US, Western Europe and (to a lesser extent) Japan. However, during the last decade the relevance of developing countries in global innovation networks has increased substantially. This can be ascribed largely to the sharp increase in new R&D investments by MNCs in China and India during the last decade, although starting from a very low base: the number of R&D centres owned by foreign MNCs rose from only 100 in each of the two countries in 2001 to 1100 in China and 780 in India by the end of 2008 (Bruche, 2009). According to Jaruzelski and Dehoff (2008) eighty-three percent of all new R&D sites opened between 2004 and 2007 by the largest 1000 MNCs by R&D expenditure were located in China or India.

Unquote

3.3 The NASSCOM has acknowledged that new software product companies are enrolling as its members. About 30 software product firms, who are also members of software body NASSCOM, have formed a policy think tank called

[5] Guimon, Jose, PhD, Global trends in R&D–intensive FDI and policy implications for developing countries, page 6.

Indian software product Industry Round Table or 'iSpirit' to share expertise and further develop the software products industry in the country.

3.3.1 This phenomena has also been highlighted by Nirmalya Kumar[6]/ Panish Puranam in their book, 'India Inside', wherein they have stated as follows:

Quote:

In many of the captive units we researched for this book, we found instance of truly novel and unique technology developments for global market. Yet global consumers rarely recognize India as the country of origin, because most of this innovation takes place in the B2B context. When we refer to the B2B context, we do not necessarily mean only product or service markets in which the customers are firms, rather than individual consumers. Instead we mean that the innovation occurring in these Indian captive units is visible only to other business units, whether within or outside the MNC, regardless of who purchases the final product.

To understand the nature of this invisibility, consider the idea of segmenting R&D activities that is, breaking activities down into smaller parts that can be performed in different geographies. An obvious segmentation of R&D is vertical, into processes that capture customers, requirements, generate product specifications, search out technological solutions to meet the desired specifications, prototype the results, and then manufacture and sell the results of the process. This type of segmentation creates a strong sense to sequence: one process requires the preceding processes to have been conducted, if not completed. Another method is horizontal – a kind of segmentation that often arises

[6] Kumar, Nirmalya and Panish Puranam, India Inside, Ed. 2012, Harvard Business Review Press, Boston, Massachusetts, Pages 31-32.

from complex, multi component technologies, such as engines, IT hardware, or even complex software. The various components involved, in principle, could be developed in parallel, as long as the component interfaces support eventual assembly and interoperability.

Unquote

3.3.2 Jose Guimon,[7] (ibid), quoting Velde, states:

Quote:

According to Velde (2001), pro-active and strategic FDI policy interventions affecting the dynamic pattern of national comparative advantages become necessary in order to avoid the risk of low-skill, low-income trap. Lall (2004) also argues that the need for policy intervention has become stronger given the fast pace of globalization and technological change. Attracting R&D–intensive FDI requires a more proactive kind of intervention, unlike generic FDI policies which can rely largely on investment liberalisation along with marketing and promotion.

Unquote

3.3.3 R & D is being increasingly undertaken in developing countries due to various factors called 'push and pull' or 'demand and supply'. As Rakesh Basant and Sunil Mani state in their working paper for IIM Ahmedabad,[8] -

Quote:

Push (or demand) factors include increasing competitive pressure that firms in developed countries have to face. These include increase in

---

[7] Guimon, Jose, PhD, Global trends in R&D–intensive FDI and policy implications for developing countries, page 9.

[8] Basant, Rakesh and Sunil Mani, Foreign R&D Centres in India: An Analysis of their Size, Structure and Implications, W.P. No. 2012-01-06, January 2012, IIM Ahmedabad, pages 24-25.

international competition and increased importance of product performance and quality based competition. There are also pressures to shorten international product penetration of new products and need to launch products in different markets simultaneously. Such competition seems to be accompanied by simultaneous processes that not only increase product differentiation but also homogenize markets globally. Such changes require firms to innovate rapidly and at lower costs but the cost of R&D in developed nations are on the rise and at times relevant scientific manpower is simply not available. With the increase in technology intensity and complexity of innovative products, process and services and the multi-disciplinary nature of R&D activity, firms find (internal capabilities to be either inadequate or too expensive. The sharp declines in product (Services) life cycles also enhance the need to reduce cost and increase the speed to market. Decentralization of R&D is seen as a response to these competitive and associated pressures. The emergence of ICT that facilitates rapid and meaningful interaction across geographies has also enhanced the potential of decentralization. Change in technologies and use of ICT also create opportunities for increasing modularity of innovation and different modules can potentially be developed in different locations.

Given the 'push' factors, availability of R&D skills at competitive wages, a well-developed nation innovation system, globalization of production requiring R&D in proximate regions, market demand for R&D based products can act pull factors for R&D activity in a specific region. For example, Mitra (2007) argues that that salaries of researchers account for about 45 percent of total R&D expenditure in the US and if the same is undertaken in India, the costs can much lower. Based on the information available to him for the year 2005, his estimates suggest significant cost savings.

Unquote

3.3.4 The above view is also supported by Jose Guimon,[9] (ibid) as follows:

- *R&D-intensive FDI may be demand-driven, supply-driven or efficiency-seeking.*
- *Demand-driven R&D is associated with knowledge-exploiting motivations and primarily oriented towards the adaptation of products, services or processes to overseas markets. Demand-driven and efficiency-seeking R&D subsidiaries tend to focus initially in lower-end and routine R&D activities (Manning et al., 2008).*
- *Demand-driven R&D is often closely connected to the internationalization of manufacturing operations and attracted by large and dynamic markets.*
- *Whereas supply driven R&D is related to knowledge-augmenting motivations, i.e. to tapping into foreign sources of knowledge. In this case the location decision is driven by the quality of local universities, human capital, research infrastructure and the presence of specialized clusters, rather than by the size or dynamism of the domestic market.*
- *In other circumstances the international allocation of R&D is driven mainly by efficiency-seeking motivations, where certain segments of the R&D value chain are relocated to lower cost locations.*
- *These different strategic motivations are closely related to the distinction between competence creating and competence exploiting mandates of MNC subsidiaries (Cantwell and Mudambi, 2005).*

[9] Guimon, Jose, PhD, Global trends in R&D–intensive FDI and policy implications for developing countries, page 7.

- *In practice, the different R&D motivations are often hard to differentiate, and a single subsidiary may undertake different R&D projects, some of them demand-driven, others supply-driven, etc.*
- *The strategic content of international R&D mandates evolves through time in response to changes in corporate strategies and subsidiary competencies.*

3.3.5 He further highlights conclusions by others in this regard as follows[10],-

Quote :

Puga and Trefler (2010) suggest that developing economies normally engage initially only in incremental (rather than radical) R&D, related to addressing production-line bugs and suggesting minor product improvements. But these lower-end R&D activities may act as a seed in the sense that, with time, they may enable a shift towards higher value adding R&D activities following learning and competence building in the subsidiaries (Chaminade and Yang, 2008; Medcof, 2007; Puga and Trefler, 2010). Indeed, the developmental impact of demand-driven and efficiency-seeking R&D should not be neglected. Rather, such R&D activities should be seen as an invaluable opportunity for an evolutionary upgrading of technological capabilities.

Unquote

3.4 **Size and Characteristics of the sector**

3.4.1 Rakesh Basant and Sunil Mani, in their W.P,[11] have referred to a 2006 study by TIFAC and summarized the main findings of the study with regard to FDI in R&D as follows:

[10] Ibid, page 8.

- R&D Services has emerged as the third segment in Export of IT Services - it occupies a share of 18.4% of software exports accounting for an annual value of $2.3 billion (during 1998-2003).
- R&D investment worth of $1.13 billion has flowed into India during the five year period 1998-2003.
- US is the largest investor followed by Germany, Korea, France and Japan. China too has established centres in India.
- The study identified 100 R&D centres employing 22980 scientists and engineers.
- Lower costs and availability of scientists and engineers are the main determinants.
- IT and Telecom, followed by pharmaceutical, auto and chemicals in general are the major industries attracting FDI in R&D.
- Nearly half the FDI companies are cases of relocation of in-house R&D in home country to offshore location in India.
- Partnerships with local companies are good at the start but partnerships are not forever – 56 percent of FDI companies prefer to work alone in India, with 100% foreign equity without local partners in equity.

Source: TIFAC (2006)

3.4.2 A study[12] by Zinnov Management Consulting shows that India accounts for a small proportion of the total R&D investments by global companies despite having a strong talent pool across verticals (**Annexure-III**).

[11] Basant, Rakesh and Sunil Mani, Foreign R&D Centres in India: An Analysis of their Size, Structure and Implications, W.P. No. 2012-01-06, January 2012, IIM Ahmedabad, page 29.
[12] Zinnov Management Consulting, Global R&D Benchmarking Study – F.Y 2011, June, 2012.

3.4.3 Rakesh Basant and Sunil Mani[13] have also stated in their paper;

Quote:

Further, we compared the list of centres arrived at by Zinnov with those arrived at by the original 2006 TIFAC study. So the total number of foreign R&D centres operating from India is reckoned to about 639 as on January 2010 although according to Zinnov (2011) this is about 871 by December 2010. A recent TIFAC sponsored study (Mrinalini, et al, 2010) arrives at a total number of 700 although even in this study the criteria for identifying the R&D centres is not spelt out in explicit terms. In sum, all estimates of the number of foreign R&D centres are mere guesstimates and its exactness may not be taken for granted but only as a broad approximation.

Unquote

3.4.4 Jose Guimon,[14] (ibid) has also observed that,-

Quote:

R&D-intensive FDI is expected to bring significant benefits to host countries by enabling an upgrading of technological capabilities as well as a better access to international markets (Cantwell and Piscitello, 2000; Carlsson, 2006; Santangelo, 2005). In view of the potential benefits, attracting (and embedding) R&D-intensive FDI is becoming a critical concern for policymakers across developed and developing countries alike. But the benefits associated with R&D-intensive FDI do not accrue automatically; a threshold level of absorptive capacity is required in order to tap into the

[13] Basant, Rakesh and Sunil Mani, Foreign R&D Centres in India: An Analysis of their Size, Structure and Implications, W.P. No. 2012-01-06, January 2012, IIM Ahmedabad, page 31.
[14] Guimon, Jose, PhD, Global trends in R&D–intensive FDI and policy implications for developing countries, page 2.

potential externalities. The impact of R&D-intensive FDI on host countries comprises direct and indirect effects (Gorg and Strobl 2001; Narula and Dunning, 2010).

Unquote

Absorptive capacity has been defined in his paper as the firm's or country's ability to acquire, assimilate and exploit knowledge developed elsewhere.

3.4.5 As stated in the first report of the Committee, NASSCOM has given three types of contractual structures prevalent in India in this sector. This is reiterated below for the purpose of easy reference.

CONTRACTUAL STRUCTURES		
Contracted Development	**Cost Sharing/ Contribution**	**Entrepreneur**
• Parties of service provider and service recipient have contractual agreement. • Service provider has no ownership/ rights on IP associated with work Product: does not contribute any IP either. • Service recipient assumes all risk associated with work product. • Service provider is generally compensated on commercial basis (hourly/ lump sum for 3rd party, and cost plus for internal)	• Parties agree to form partnership to pool respective IP, and share risk and reward from future R&D • Both parties contribute IP, or share the costs thereof and have joint ownership of any IP developed going forward. • Parties jointly share the risks, in their cost sharing ratio. • Parties agree to jointly share the profits associated with the IP developed, as per mutually negotiated terms.	• The company undertakes the R&D on its own account and bears full risk and reward from future R&D. • The company bears the costs of R&D and has ownership of IP developed. • The company enjoys the profits associated with the IP developed.

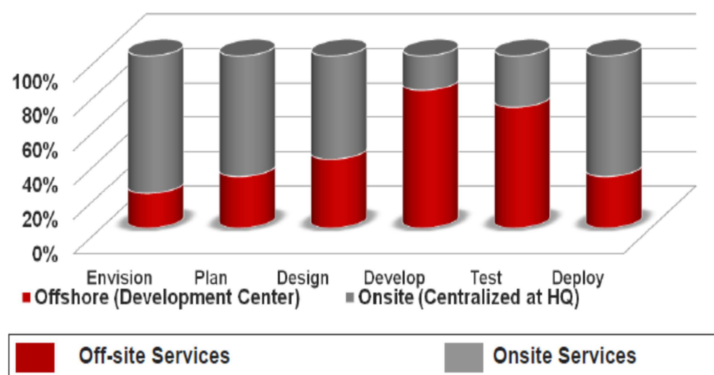
3.5 In this context, the position of NASSCOM, as stated at Para 2.9.3 of the First Report of the Committee is relevant and, thus, is reproduced below for the sake of clarity:

"2.9.3 Most software projects follow a "distributed development" model with phases and parts of the projects performed across different sites or departments, with work packages delegated to external vendors (i.e., outsourcing) or transferred to offshore captive service providers, for instance in India. The overwhelming majority of captive IT Development Centres in India and their Principal R&D Company fit in the above profile."

3.5.1 Typical features of such a model, as described by NASSCOM and already included in the first report of the Committee, are as follows:

- In the Indian context, captive Development Centres do not operate with any autonomy; any work, suggestions and inputs of the captive Development Centres in India are always subject to review, modification and approval of the principal R&D Company. The functions of development, enhancement, maintenance and protection of the intangibles are entirely controlled and performed by the principal R&D Company. Risks and control of the costs relating to development, protection and maintenance of intangibles are also completely borne by the principal R&D Company.

- Some portions of each of these activities are carried on from India (Offshore) and other portions at the site of the customer or at the HQs of an MNC (Onsite). The proportion of onsite to offshore work for each stage may differ from Development Centre to Development Centre.



- An overwhelming majority of captive R&D Development Centres in India and the Principal R & D company have the following functional profile, in relation to the IT Development Centres rendering contract R & D services:

  1. Principal R&D Company is responsible for the overall research programme and funds the entire cost of R & D including a service fee to Development Centre and allocates budgets to various researchers.

  2. Principal R&D Company designs research programmes, makes decisions as to where R&D activities will be conducted, and regularly monitors the progress on all R & D projects.

  3. Principal R & D Company controls the R & D function for the MNE group and the R&D programme of the group operates under strategic direction of the senior management of the principal R & D Company.

  4. Contracts between the principal R & D Company and Development Centre specify that principal R & D Company will bear all risks and costs related to R&D undertaken by Development Centre.

  5. All patents, designs and other intangibles developed by Development Centre research personnel are registered by principal R&D Company, pursuant to contracts between the Development Centre and principal R&D Company.

6. Personnel of Development Centre may be involved in planning and design by virtue of giving suggestions for modifications to the research programme and such suggestions are required to be reviewed and approved by the principal R&D Company.

- In a scenario such as the above, where the principal R&D Company bears the risk of failure of the research and will be the owner of the outcome; the contract researcher is paid a guaranteed remuneration irrespective of the outcome of the research; and the principal R&D Company makes a number of relevant decisions in order to control its risks, it would be a typical case for only the principal R&D Company to be entitled to all the intangible related returns and the Development Centre to be compensated on a total cost plus basis.

- For a member of an MNE group to be entitled to intangible related returns, it should in substance,-

  i. Perform and control important functions related to the development, enhancement, maintenance and protection of the intangibles and control other related functions performed by independent enterprises or associated enterprises that are compensated on an arm's length basis;

  ii. Bear and control the risks and costs related to developing and enhancing the intangible; and,

  iii. Bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns.

- In the cases of captive R&D centres operating in India, it is not only that the legal and economic ownership lies with the overseas principal R&D Company but it also has to be appreciated that any patent registration, based on contribution by India, cannot be commercially exploited on a

standalone basis. Such Patent registration is only to safeguard the legal rights of the principal against infringement of IP (by competitors), however insignificant these rights may be. The Principal has rights to make decisions with respect to the following:

– Hiring/Terminating services of contract researcher
– Type of research to be carried on and assigning objectives
– Budget to be allocated for research
– Assessing outcome of the research....test, review & evaluate results
– Setting stage for decision making

3.6 In this context, para 2.10 of the first report of the Committee, wherein the view of the Revenue[15] is mentioned, may be referred to. The important contentions contained therein are summarised as follows:

- The DCs in India are engaged in R&D activities for development of new product (including software development) and services, development of design and development of part of product or services which go as input to final product/services being developed by parent company.

- These research and development activities may be classified into two categories:
  - Primary function of R&D activity is to develop new product/services or inputs.
  - Other function is to discover and create new technology, design, methodology, for development of new product, process and services.
- Different companies adopt different models and type of R&D activities and ratio of research and development of the revenue varies significantly.
- The categorization of off-shore development centre in India may be on the basis of type, model and nature of R&D activity and reason and benefit of

[15] JS FT&TR, CBDT and agreed by DGIT (International Taxation)

off-shoring. It may be very difficult to make exact groupings of R&D development centres because of above parameters, which may vary from one industry to another industry segment in each country.

- The contract development structure as mentioned in NASSCOM presentation will need further examination by analyzing actual contract in case of entities engaged in R&D activities, product and services development, design development etc. It may be seen from presentation that NASSCOM has admitted that services provider also bears the risk of R&D activities in case of contracted R&D and is not a risk free entity. Accordingly, the remuneration model will vary from case to case depending upon FAR analysis.
- Contractual agreements vary with the companies and it may be difficult to construct a homogenous group on the basis of contractual agreement.

3.7 As regards the compensation model, the Indian industry, as quoted in the first report of the Committee, is of the view that,-

Quote:

2.13.1 Indian R & D Centres of MNCs are entitled only for appropriate cost-plus return for the contract R & D work performed and not entitled to any intangible related returns.

2.13.2 In a scenario where-

- *the principal R& D company bears the risk of failure of the research and will be the owner of outcome;*
- *the contract researcher is paid a guaranteed remuneration irrespective of the outcome of the research;*

- *the principal R & D Company makes a number of relevant decisions in order to control its risks;*

  It would be a typical case for only the principal R & D Company to be entitled to all the intangible related returns and the Development Centre to be compensated on a total cost plus basis. A large majority of R & D centres operating in India today would be covered under the fact pattern discussed above. Transactional Net Margin Method would be the only appropriate transfer pricing method to benchmark the transaction of rendering services by Development Centres to the Principal R & D Company with appropriate mark-up on cost.

Unquote

3.8 As regards methodology for benchmarking, industry is of the view (reference paragraphs 2.13.3 - 2.13.5 of the first report of the Committee) that,-

Quote

- *application of PSM requires exceptional circumstances, for example:*
  - *(i) where an MNC undertakes the R & D under a cost contribution arrangement- Under such an arrangement, all the parties contribute costs and resources and jointly undertake R & D and share the risks and rewards of such R & D. In this arrangement, the participants in the R & D process get part legal and economic rights in the intangibles and hence the participants would be entitled to intangible related returns. It is a possibility that some of these arrangements may entail a PSM for compensation to all the participants; or*
  - *(ii) where the Principal is located in tax havens/tax shelters with no significant functions performed or decisions taken outside of India.*

- *Application of PSM by India will increase the overall cost of undertaking R&D work in India, though the quantification for the same would depend on varied factors. Also, lifecycle of an R&D program tends to be long (average lifecycle of an R&D program exceeds two years) with new programs starting regularly. Thus, an MNC looking to setting-up an R&D centre would seek a greater degree of certainty of the tax policy applicable in order to meet its long-term objectives. It is therefore imperative that transfer pricing policies for R&D centres in India are carefully and pragmatically implemented keeping in view that India would like to retain its competitive position.*

- *The complex transfer pricing issues need better understanding of the larger R & D program of an MNC and a careful study of the functional analysis in most cases would reveal that cost plus method would be applicable. Both taxpayers and tax authorities need to work together to ensure that this understanding increases quickly. In the meantime, the tax authorities need to resist the temptation of using PSM on a generalized basis to drive revenue collection when indeed the same would be grossly incorrect for most contract R & D arrangements in India today.*

Unquote

3.9 As mentioned in paragraph 2.9.2 of the first report of the Committee, the views of Revenue on profile of a Development Centre and methodology for benchmarking are as summarised below:

- Development Centres are no longer limited to standardized information and technology but increasingly involve product development function (engineering, R&D) and product design. Also distinction between home based and foreign-based development centres has disappeared. These DCs are transferring intellectual property, the value of which is not known

to the DCs. The FAR i.e. Function, Asset and Risk Profile of a DC will depend on nature, business model, reasons and benefits of off-shoring, etc. In this regard, functions, assets and risks are equally important. Since risk is a by-product of functions performed and usage of assets, it should be considered together with functions and assets.

- The difference between controllable and un-controllable risks needs to be distinguished. Business model, nature, reasons and benefits of off-shoring are important factors in determining allocation of risks. The various factors that are to be seen while determining the entity controlling a risk are such as core functions, key decisions, level of individual responsibility etc. The most appropriate method will vary with the functional profile of the Development Centre and there cannot be any straitjacket formula for applying cost plus method / TNMM. Undue emphasis on risk, without realizing that the risk is a by-product of function and asset, may give wrong result. The risk is located where the functions and assets are located. However control over risk may be divided between parties. Location savings and location rents also need to be considered. For intangible related returns, in situations where the R&D Centre is an entrepreneur or is working under a cost contribution arrangement, Profit Split Method (PSM) may be a more appropriate method but the current methods being followed by the Department for applying PSM, such as those based on R&D head count, may not be appropriate.

- The Offshore Development Centres in India are developing significant intangibles, known by the patents being filed from India in US and other countries. These are valuable and unique as it can be seen from Indian Patent Act, 1972 that only those inventions, which are valuable and unique, can be patented. Further Indian TP regulations justify the application of PSM when intangibles are involved. The example of patent

battle between Samsung and Apple in which Apple won the legal battle in USA for a $1 billion payout from Samsung demonstrates the value of patents.

- The Issue of attribution of global profits under profit split method needs a careful scrutiny in order to understand the extent of the problem.

3.10 As mentioned in the first report (para 2.15.1), the Committee acknowledges that Research and Development function can be broadly categorised in the following three baskets, [16] i.e.,-

- Full risk bearing developer viz. an entrepreneur
- Limited risk bearing developer viz. one who works under a cost contribution arrangement
- Contract R & D service provider with no significant risks viz. one who works under an assured return basis

3.10.1 Further, whenever industry refers to cost-plus or appropriate mark-up on cost, the reference is to profit margin under Transactional Net Margin Method on cost. The profit margin is computed on cost, excluding interest and tax. As most of the captives follow cost plus business model, the principal reimburses all the costs (before interest and tax) with certain agreed mark-up. The costs that are considered (before interest and tax) for applying TNMM for the captive and the comparables also form the cost base for reimbursement by the principal. Thus, as per industry, appropriate mark-up on costs in effect refers to the appropriate operating margin under TNMM and cost plus method referred by the industry, in effect is TNMM under the Income Tax Act.

[16] Report of Committee on Transfer Pricing Audits headed by B.D Bishnoi, DIT TP-Delhi, August, 2007, Paragraph 6.48, page 48.

3.11 In Para 2.19.2 of the first report, the Committee has already acknowledged the recommendations made by an earlier Committee[17] set up by the then DGIT (International Taxation) in 2007 under the then DIT(TP), Delhi, which stated that Economic characterisation of R&D function can be illustrated as follows:

- Full risk bearing developer of intangibles
- Limited risk bearing developer of intangibles
- Contract R & D service provider with insignificant risks

3.12 The Committee, in this report, is suggesting Safe Harbour for such R&D service providers who act as contract R&D service providers with insignificant risks**.** The Committee is of the view that R&D centres which bear full risk as developers of intangibles (viz. who are Entrepreneurs) and limited risk bearing Developer of intangibles (viz. who follow cost sharing /contribution models) need a case specific FAR analysis and no general Safe Harbour can be designed for such cases.

3.13 In its second report (first on Safe Harbour), the Committee had emphasised that, *"There should be a clear definition of what constitutes IT - Software Services and IT Enabled Services. Besides, the definition of R&D in IT Services is also required."* Consequently in para 3.5.1 of the Safe Harbour report on IT and ITES, the activities covered in the two sectors were defined. It had also been stated therein that R&D Services within IT Sector would have a separate set of Safe Harbour rules.

3.13.1 To recapitulate, Para 3.5.1.1 of the second report of the Committee on safe harbour for IT/ITES, provides a list of activities constituting Information Technology (Software Sector). These activities are of a routine nature, such as business application software and information system development using known

[17] Para 6.48 supra

methods and existing software tools; support for existing systems; converting and/or translating computer languages; adding user functionality to application programmes; debugging of systems; adaptation of existing software; and preparation of user documentation, that do not involve scientific and/or technological advances or resolution of technological uncertainties;

3.13.2 Para 3.5.1.2 of the report referred supra, lists the services constituting Information Technology Enabled Service (ITES) i.e., any service provided mainly with the assistance or use of Information Technology such as back office operations, call centres or contact centre services; data processing and data mining; clinical database management services, etc.

3.14 In view of the above discussion, what is the definition of R&D in software is a key question. In an article,[18] Avron Barr and Shirley Tessler have stated,-

Quote:

Software R&D spans a set of tasks including conception, design, specification, code development testing, and documentation. In the past decade, most software outsourcing projects have focused primarily on development and testing from clearly –defined and well-specified requirements provided by the outsourcing organization. In the more cutting-edge outsourcing endeavours, which have begun appearing more regularly in recent year all parties to the project are involved with all stages, including the design, since it necessarily evolves iteratively with development, and is therefore much less amenable to formal specification. Software R&D culminates in a finished program or systems, not in an input that gets combined with other inputs in some proprietary way, and certainly, not a discovery or invention whose commercial impact then

[18] Barr, Avron and Shirley Tessler, The Globalisation of Software R&D: The Search for Talent, Stanford Computer Industry Project.

depends on a secret process or methodology in the manufacture of the final product.

Unquote

3.15 OECD's Frascati Manual, 2002 defines the phrase research and development [19] as,-

Quote:

Research and Experimental Development (R&D) comprise creative work undertaken on systematic basis in order to increase the stock of knowledge, including knowledge of man, culture and society, and the use of this stock of knowledge to devise new application.

Unquote

3.16 Discussion within the Committee as to what constitutes IT Research and Development services also considered the categorisation of the IT industry itself as given in the Economic Survey. Besides, as already articulated in the first Safe Harbour report for IT and ITES sectors, some activities were excluded from routine ITS and ITES activities, as in the view of the Committee they constituted R&D (reference para 3.5.1.1 of the said report). The same have been detailed in the recommendations of the Committee contained in Part – 4 of this report.

3.16.1 Those activities are considered as distinct from software-related activities of a routine nature because they do not involve scientific and/or technological advances or resolution of technological uncertainties. Further, even though Avron Barr and Shirley Tessler state that, "*Software R&D culminates in a finished program or systems, not in an input that gets combined with other inputs in some proprietary way,*" the Committee is of the view that though the captive DCs may not be participating in the complete research for a finished product, they are definitely engaged in developing a component of some

[19] http://www.oecd-ilibrary.org/science-and-technology/frascati-manual-2002_9789264199040-en

value for the said product. The research may be multi-locational and this must be taken cognisance of.

3.17 Methodology

3.17.1 At this stage, it is important to consider the relevance of the 4 Cs of outsourcing i.e. Credibility, Capability, Capacity and (right) Costs. They must be factored in while finalising the margins for comparability analysis for Safe Harbours.

3.17.2 The Committee has taken note of Country Practice – India (Para 10.3.8.11) appearing as part of Chapter 10 in UN's Practical Manual on Transfer Pricing for Developing Countries, 2012 of the UN TP Manual, wherein the position of India has been that in cases where the India-based R&D centre is engaged in the creation of unique intangibles, additional compensation must be allocated for transfer of intangibles in addition to the arm's length compensation for the R&D activities.

3.17.3 There is a view within the Committee that Safe Harbour margins must recognise the following factors, which support outsourcing of R&D activities to India:

- The captive DC conducting research provides a competitive advantage to its parent in terms of costs and professional competence arising due to locational advantage. India has unique location-specific intangibles such as skilled workforce, connectivity facilities, lower costs and global delivery model, which is, as claimed by NASSCOM, an Indian innovation.
- In addition to the above, the issue of market premium also needs to be factored in.

3.17.4 An alternate view within the Committee is that market premium or location savings need not be factored in. The comparables chosen for the purposes of evaluation of whether the pricing is at arm's length operate in the same location and enjoy the same market premium or location savings as are enjoyed by the Indian captive service providers. As such, once an arm's length price is worked out and is factored in, evolving a safe harbour, there is no question of incremental factoring in of market premium or location savings.

3.17.5 After considerable discussion, the Committee decided to consider an all inclusive premium amount over and above the basic rate for this sector. In the view of the Committee, Safe Harbours may be considered only for enterprises carrying out contract R&D with insignificant risks. In other cases, where there is a cost sharing or cost contribution arrangement (CCA) or entrepreneurial activity, appropriate FAR analysis needs to be done on case specific basis, and hence no Safe Harbours are recommended for these situations.

***

PART 4 - RECOMMENDATIONS

4.1 Keeping in view the existing provisions of the Act and the directives as contained in the press release of the PMO, dated 30.07.2012, the Committee recommends that Safe Harbour provisions should be applicable to enterprises in contract R&D in the IT sector. **An enterprise eligible for Safe Harbour may be called an 'Eligible Enterprise' and all the transactions that are eligible for Safe Harbour may be called 'Eligible International Transactions'.**

4.2 The Committee recommends that the Government may consider the following while framing Safe Harbour Rules for Eligible Enterprises opting for Safe Harbour in contract R&D in the IT sector.

4.3 **General Recommendations**

- The taxpayer should have the option of whether to go in for Safe Harbour or not and it should not be mandatory. However, Safe Harbour should not become a rebuttable presumption for a taxpayer who opts not to go for it and has an ALP below the Safe Harbour. There has to be a directive to the Assessing Officer/TPO in this regard that they can get the international transactions bench-marked but cannot force the taxpayer to rebut the presumed ALP.
- Safe Harbour would not be available to a taxpayer whose profits are higher than the Safe Harbour margins on account of its contracted price and such a taxpayer cannot be assessed at the lower presumptive ALP corresponding to the Safe Harbour.
- Safe Harbour margins recommended may be made applicable from A.Y 2013-2014, for a period of two years.

- Further, an institutional mechanism needs to be evolved so that every two to three years, the Safe Harbour rules/margins/rates are reviewed and notified in advance so that the taxpayers can comply with such provisions with ease.

- If any other international transaction is otherwise eligible for Safe Harbours, such as, loan, etc., it will continue to be an Eligible International Transaction for the purposes of Safe Harbour.

- Safe Harbour provisions may not be applicable if the Eligible Enterprise renders services in the nature of Eligible International Transactions to any Associated Enterprises (AE) located in jurisdiction as notified under section 94A of the Income-tax Act or any other country/territory widely perceived as a tax haven.

4.4 Recommendations on threshold

4.4.1 The existing limit of Rs. 1 crore provided under sub-rule 2 of Rule 10D was fixed more than a decade ago. NASSCOM has strongly demanded an upward revision. This upward revision is also justified to adjust for inflation. It may be mentioned that change in monetary parameters on account of inflation factor is part of our tax policy as is evident from the fact that the monetary limit for audit of accounts of certain persons engaged in business, as provided in section 44AB of Income Tax itself, has been revised upwards from Rs. 40 lakhs to Rs. 1 crore during the corresponding period.

4.4.2 **Accordingly, the Committee recommends that the exemption from maintaining information and documentation for international transactions specified at Rs. 1 crore under sub-rule 2 of Rule 10D of the Income-tax Rules be raised to Rs 5 crore as it will reduce compliance cost for small tax payers. Tax**

administration will have a smaller basket for picking up cases for scrutiny facilitating optimum use of its resources.

4.4.3 The present practice of authorising the Assessing Officer (AO) to do transfer pricing audit in select number of cases, where the aggregate value of international transactions is less than the threshold limit (Rs. 15 crore), has reduced the applicability of the threshold limit as a Safe Harbour while simultaneously diluting the effectiveness of transfer pricing audit. **The Committee, therefore, recommends that the threshold of Rs.15 crore as an administrative Safe Harbour should be specified as a statutory Safe Harbour rule itself.**

4.5 Specific Recommendations

4.5.1 In the view of the Committee, the following activities undertaken partly or fully constitute R&D:

- R&D producing new theorems and algorithms in the field of theoretical computer science.
- Development of information technology at the level of operating systems, programming languages, data management, communications software 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 for capturing, transmitting, storing, retrieving, manipulating or displaying information.

- Experimental development aimed at filling technology knowledge gaps as necessary to develop a software programme or system.
- R&D on software tools or technologies in specialised areas of computing (image processing, geographic data presentation, character recognition, artificial intelligence and other areas).

4.5.1.1 In addition, the Committee clarifies that the following activity may also constitute R&D:

- Upgrades of existing products even where the source code has been made available by the parent/principal.

4.5.1.2 The **'Eligible International Transaction'** shall be the rendering of contract R&D services, partly or fully, in the IT Sector by the **'Eligible Enterprise'**.

4.5.1.3 The Safe Harbours recommended in this report would be applicable to an Eligible Enterprise that meets the following conditions (to be met cumulatively) so as to be treated as a Contract R&D service provider with insignificant risk and the most appropriate method in such cases would be the Transactional Net Margin Method (TNMM) with an applicable mark-up as suggested by the Committee (the conditions mentioned below are in accordance with the broad principles enunciated by the Committee in Para 2.15.3 of its First Report):

- The critical functions with regard to R&D Services, including particularly conceptualization and design i.e., concurrent engineering, for the product or component of a product, are driven by the foreign principal.
- The principal provides funds/capital for such Services. The principal bears the risk of failure of the research and development and will be the owner of the outcome of such R&D and also any intangible generated in

rendering such R&D services, while the Eligible Enterprise is allocated a guaranteed remuneration on services pertaining to Eligible International Transactions, irrespective of whether the outcome of such R&D is a success or a failure.

- The Eligible Enterprise is required to report back to the principal on a regular basis, e.g. at pre-determined milestones. The principal is expected to be able to assess the outcome of the R&D activities. Any suggestion to the modification of R&D programme by the Eligible Enterprise is subject to the review and approval by the foreign principal who makes the relevant decisions to control the risks.
- The Eligible Enterprise, in respect of R&D services pertaining to Eligible International Transactions, does not assume risks or has insignificant realised risk such as market risk, business risks, economic conditions risk, credit & collection risk, capacity utilisation risk, quality risk product / service acceptance risk, product development risk, infrastructure utilisation risk, intellectual property infringement risk.
- The entirety of the product life cycle and / or software development life cycle is not undertaken by the Eligible Enterprise.
- The Eligible Enterprise, as contract R&D service provider, has no right to ownership on the outcome of any intangible generated or arising during the course of rendering such R&D services. The rights in the developments contractually vest since inception with the foreign principal and the registration of any IP arising from such development is made by the foreign principal. Involvement of the Indian personnel to comply with filing requirements, without any underlying rights in the exploitation by the Indian personnel and / or by the Eligible Enterprise, is evident from the

employee contract and / or contract between Eligible Enterprise and its foreign principal.

- The patent registration, if any, cannot be commercially exploited on a standalone basis and its value is indeterminate.
- The terms and conditions regarding ownership of intangibles would have been similar if the R&D activities carried on by the Eligible Enterprise were or could have been outsourced to a third party.

4.5.2 Margin for Safe Harbour and Most appropriate method

4.5.2.1 Various reports in public domain indicate that India is moving towards high-end R & D activities in the IT sector. Further, there would be some additional return expected for economic value addition generated through R&D intangibles, which physically manifest as patents, as well as for locational advantages offered by a low cost economy like India which has a large trained pool of engineers and scientists with comparative lower costs and higher capabilities. The Data received from the Department [office of DGIT (International Taxation)] (**Annexure IV**) revealed that the average margins considered by the TPOs for A.Y 06-07 is 22.57% while that for A.Y 09-10 is 61.32%. The data received from the Department was examined but was not relied upon by the Committee for the following reasons:

- The Department has been adopting two broad categories of IT Services and ITEs as opposed to greater vertical segmentation made by the industry body NASSCOM, as well as, in the Economic Survey of India for 2012-13 (reference para 3.1of this report.)
- The sample size is very small with only about 4 to 5 companies being categorised as entities doing contract R&D in the IT sector though there

are many R&D centres in India in the IT sector and no reliable inference could be made from such a small sample;

- High variations in the margins declared by these companies [16.28% being the highest and 4% being the lowest] and also in the margins determined by the TPOs [108.02%[20] being the highest and 5.67% being the lowest] indicate extreme volatility, which is not conducive for any statistical inference; and
- There are hardly any comparable companies doing R&D in IT sector as significant R&D is outsourced to captive in India.

4.5.2.2 The potential of third-party vendors in software R&D is still unexploited. Zinnov's study[21] on Software R&D Globalization indicates that only 5% of R&D budgets are currently being spent on outsourced partnerships (third-party vendors), which means about 95% of the R&D is conducted by companies in-house (HQ, Captive models). Further, for many of the large sized companies that participated in the Zinnov survey, mature/ existing products accounted for more than 75-80% of their total revenues, and hence they have to invest heavily on maintaining and enhancing these products to suit requirements.

4.5.2.3 Amitava Roy, COO, Symphony Services[22], says,-

Quote:

Most software companies are looking to maximize ROI from their software products, while extending their output from their R&D teams on newer products. Over 80% of total software R&D spend goes towards activities to support the products that are in maintenance mode. Yet margins on new

[20] This margin was arrived at by doing a corroborative TNMM analysis to the main PSM done in the order. The margin is inclusive of comparables margins (52.78%), location savings and additional return on R&D.

[21] Zinnov Management Consulting, Global R&D Benchmarking Study – F.Y 2011, June, 2012.

[22] Source: Third-party Partnerships Hold the Future in Software R&D http://www.chinasourcingguide.com/?q=en/node/10036

products are significantly higher than on maintenance contracts. This presents two major challenges to software product companies today - freeing up resources to work on new products and maintaining margins for legacy products.

Unquote

4.5.2.4 As per the Zinnov analysis, most of the routine software development services rendered from India are under maintenance contracts or popularly known as software development services, on which the margins for the MNCs are lower when compared to margins of software product MNC companies to whom R&D services are rendered from India which are utilised in the products of such MNCs (**Annexure-V**).

4.5.2.5 Since the Committee had earlier recommended Safe Harbour margins of 20% and 22% for the IT and ITES sectors, and contract R&D in the IT sector is intrinsically linked to both and in view of the limited data availability, the Committee has decided to use the 20% margin as the base rate on which the final recommended margin would be built upon. As stated elsewhere in this report, contract R&D involves work requiring higher skill sets. For doing such work, companies may incur higher expenses on employees and equipments and may also expect to earn higher profits than routine IT/ITES providers.

4.5.2.6 Since there are hardly any comparable domestic companies doing R&D in the IT sector, as significant R&D is outsourced to captive DCs in India, the issue of location savings needs to be considered. However, as noted in paragraphs 3.17.3 and 3.17.4, the views of the members of the Committee are divided on the issue.

4.5.2.7 Besides, a higher margin is also justified because market premium needs to be compensated as well.

4.5.2.8 Further, the Committee did look at some Indian companies doing R&D work in the IT sector. They are not captive entities like the Development Centres of MNEs but are entrepreneurs engaged in outsourced software product development services, product engineering, analytics, etc. The segment of R&D work could not be determined and analysed separately for lack of segmental details. Notwithstanding the fact that these companies are not doing only R&D work, the profits earned by them do indicate a trend of high earnings. The Committee found that these companies earn profits in excess of 30% on many occasions **(Annexure VI).** Though this sample is also very small in size (6 companies), the high earnings of these companies were noted. Further, though the profits earned by some of the companies were as high as 50 to 60%, the Committee recognises the fact that they are not solely into R&D areas of work but are engaged in other activities too like product development, analytics, etc.

The Committee is of the view that reasonableness demands that the Safe Harbour margin ought to be between the base rate of 20% and the high margins of 50 to 60% discussed above.

4.5.2.9 Another independent analysis done by the Committee of well known MNCs corroborates this conclusion **(Annexure-V)**. Thus, it is clear that there is a higher profit to be earned by companies by doing R&D work. The Committee, therefore, is of the view that the Safe Harbour margins for contract R&D in the IT sector ought to be higher than the 20% and 22% recommended for the ITS/ITES sectors earlier.

4.5.2.10 Considering all the above factors, the Committee is of the view that an additional 10 percentage points [on the base rate of 20%] of profits would be justified. **Accordingly, the Committee recommends a Safe Harbour margin of 30% for entities doing contract R&D in the IT sector.** The Committee believes that the twin impact of a higher margin and a larger cost base would adequately capture the tax base for such activities.

4.6 The Committee understands that for computing the above-recommended 30% margin, the method of computing the Profit Level Indicator (PLI) is of critical importance. Operating Profit Margin is the most crucial aspect for calculating the PLI. **Accordingly, the Committee recommends that "Operating Expense", "Operating Revenue" and "Operating Profit" for the purposes of calculating PLI should be defined as follows**:

- "**Operating Expense"** is the expense of the Eligible Enterprise incurred during the course of its normal operations and in connection with Eligible International Transactions for the previous year, including depreciation / amortization expenses relating to assets used by the Eligible Enterprise but excluding interest expense, provisions for unascertained liabilities, pre-operative expenses, the loss arising out of translations of foreign currency items, extraordinary and other items not relating to the operating activities of the Eligible Enterprise for the previous year, the loss on sale of assets / investments of the company, and the effects relating to the income tax expense of the company.
- "**Operating Revenue**" is the revenue of the Eligible Enterprise earned in connection with Eligible International Transactions and during the course of its normal operations for the previous year, but excluding interest income, the income arising out of translations of foreign currency items, the income on sale of assets or investments of the company, the refunds relating to the income tax expense of the company, provisions no longer required written back and extraordinary and other items not relating to the operating activities of the Eligible Enterprise for the previous year.

- "**Operating Profit**" is the profit earned from normal operations of the Eligible Enterprise. It is computed as the operating revenue of the Eligible Enterprise less the operating cost incurred for an accounting period.

4.6.1 If an Eligible Enterprise is into multiple activities other than the Eligible International Transaction (contract R&D in IT), then a certificate from the auditor may be prescribed to audit and certify the profitability arising under TNMM on account of the Eligible International Transaction.

4.6.2 Accounting terms used in these Rules shall be defined in accordance with generally accepted financial accounting principles in India.

4.6.3 **The Committee recommends that once Safe Harbour rules are opted for by a taxpayer, no margin variation benefit under section 92C(2) or any other comparability adjustment such as, capacity, risk, working capital, etc. would be permitted**.

4.6.4 To reduce compliance costs for the taxpayers, it is imperative that the documentation burden on the taxpayers opting for Safe Harbour is made less stringent, as compared to an assessee choosing regular TP documentation and scrutiny by the Department. Accordingly, the **Committee recommends that such an enterprise need not maintain information and documents specified in clauses (g) to (m) of Rule 10D(1) in respect of the Eligible International Transactions**.

4.6.5 The Committee clarifies that Safe Harbour rules would not give immunity from scrutiny of any international transaction other than the Eligible International Transactions that have been opted by the Eligible Enterprise to be covered under Safe Harbour.

4.7 Recommendations on Procedural /Administrative Issues.

4.7.1 An Eligible Enterprise may exercise its option for accepting the Safe Harbour for the year by filing an option form with the Assessing Officer not later than the due date for filing the Income-tax return. If necessary a new Statutory Form for exercising Safe Harbour option to be filed along with return of income may be prescribed. Alternately, the 3CEB Report should be modified to provide for indication of election of Safe Harbour option for the year along with identification of Eligible International Transactions.

4.7.2 The Committee recommends that the AO must compulsorily refer such cases to the TPO who will conduct the functional analysis to determine the Eligible Enterprise as well as the Eligible International Transaction before accepting the results of the taxpayer under Safe Harbour. Besides, there should be strict penalties if any of the eligible conditions laid down for Safe Harbour are violated by the taxpayer.

***

Annexure-I

PM sets up Committee to review Taxation of Development Centres and the IT Sector, Safe Harbour Provisions to be Finalised soon

July 30, 2012

New Delhi

The Prime Minister has constituted a Committee to Review Taxation of Development Centres and the IT Sector. The Committee will engage in consultations with stakeholders and related government departments to **finalise the Safe Harbour provisions** announced in Budget 2010 sector-by-sector. It will also suggest the approach to **taxation of Development Centres.**

2. The Prime Minister had earlier set up an Expert Committee on GAAR under the Chairmanship of Dr. Partho Shome to engage in a widespread consultation process and finalise the GAAR Guidelines. The response has been overwhelmingly positive.

3. While this Committee would address concerns on GAAR provisions and would reassure investors about the predictability and fairness of our tax regime, it was felt that there is still a need to address some other issues relating to the taxation of the IT Sector such as the approach to taxation of Development Centres, tax treatment of "onsite services" of domestic software firms, and also the issue of finalising the Safe Harbour provisions announced in Budget 2010.

4. Many MNCs carry out activities such as product development, analytical work, software development, etc. through captive entities in India. They exist in a wide range of fields including IT software, IT hardware, Pharmaceutical R&D, other automobile R&D and scientific R&D. These are popularly called **Development Centres**. Over 750 MNCs have such centres at over 1100 locations in India. The reason for this large concentration of

Development Centres in India is the worldwide recognition of India as a place for cost competitive, high quality knowledge related work. Such Development Centres provide high quality jobs to our scientists, and indeed make India a global hub for such Knowledge Centres. However, India does not have a monopoly on Development Centres. This is a highly competitive field with other countries wanting to grab a share of the pie. There is need for clarity on their taxation.

5. As far as **Safe Harbour provisions** are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer.

6. The resolution of the above tax issues requires a comprehensive approach in which other government departments are consulted and industry bodies are taken on board. The overall goal is to have a fair tax system in line with best international practice which will promote India's software industry and promote India as a destination for investment and for establishment of Development Centres. Therefore, the Prime Minister has constituted a Committee consisting of experts from the Income Tax Department, both serving and retired, who will examine the issues in detail and submit proposals in a short time. An arm's length exercise of this nature will allay a lot of concerns in addition to the immediate resolution of issues that is necessary.

7. For this purpose, a **Committee on Taxation of Development Centres and the IT sector** has been constituted consisting of:

1) Shri N. Rangachary, former Chairman CBDT & IRDA - Chairman

2) Ms Anita Kapur, Director General (IT) - Member

3) Ms Rashmi Sahani Saxena, DIT (TP) - Member

4) Any other officer from the Income Tax Department to be co-opted by the Chairman

8. The **Terms of Reference of the Committee** will be to:

i) Engage in consultations with stakeholders and related government departments to finalise the approach to Taxation of Development Centres and suggest any circulars that need to be issued.

ii) Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector. The Committee will also suggest any necessary circulars that may need to be issued.

iii) Examine issues relating to taxation of the IT sector and suggest any clarifications that may be required.

9. The Committee will work to the following time schedule:

i) Finalise the approach to taxation of Development Centres and suggest any necessary clarifications by **31 August 2012.**

ii) Suggest any necessary clarifications that may be needed to remove ambiguity and improve clarity on taxation of the IT Sector by **31 August 2012.**

iii) Finalise Safe Harbour Rules individually sector-by-sector in a staggered manner and submitting draft Safe Harbour provisions for three sectors/sub-activities each month beginning with the first set of suggestions **by 30 September 2012.** All Safe Harbour provisions can be finalised by **31 December 2012.**

10. The Department of Revenue will provide all necessary support to the Committee to facilitate its work including office assistance and assistance to facilitate consultations.

Annexure-II

F.No.A. 50050/103/2012-Ad.I
Government of India
Ministry of Finance
Department of Revenue
***

New Delhi, dated the 13th September, 2012.

OFFICE MEMORANDUM

Subject: Constitution of a Committee to Review Taxation of Development Centres and the IT Sector- Reg.

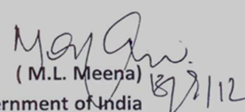
***

The undersigned is directed to refer to Department of Revenue's O.M. of even number dated 3rd August, 2012 on the above cited subject and to say that considering the paucity of adequate data required to draft the rules, the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors/activities:

(i) IT Sector
(ii) ITES Sector
(iii) Contract R&D in the IT and Pharmaceuticals Sector
(iv) Financial Transactions – Outbound loans
(v) Financial Transactions – Corporate Guarantee
(vi) Auto Ancillaries – Original Equipment Manufacturers

2. In view of the above, the revised timelines for submitting the reports on Safe Harbour provisions by the Committee have been modified as under:

First Report by 15.10.2012;
Second Report by 15.11.2012; and
Final Report by 31.12.2012.



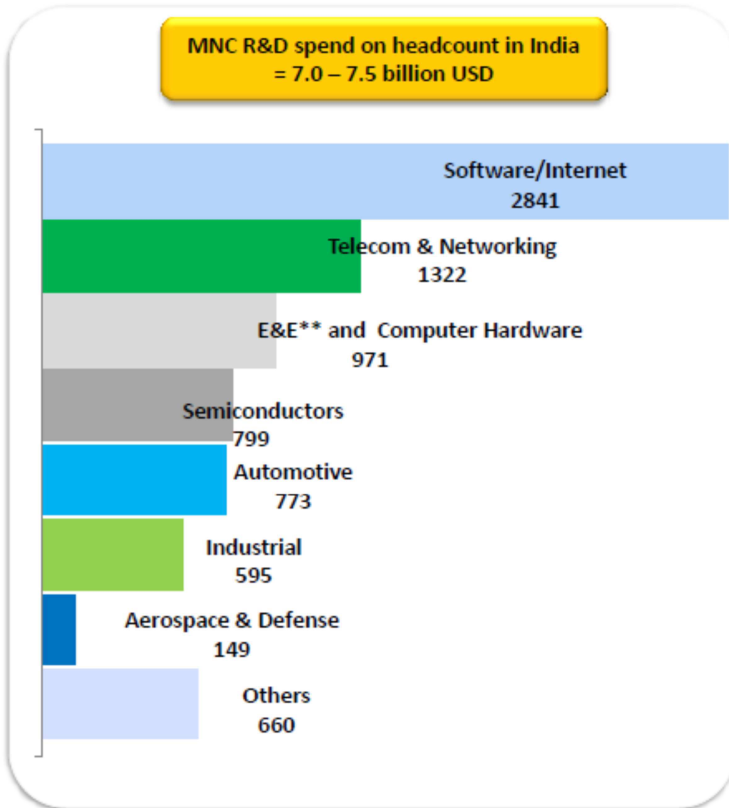
(M.L. Meena)
Joint Secretary to the Government of India

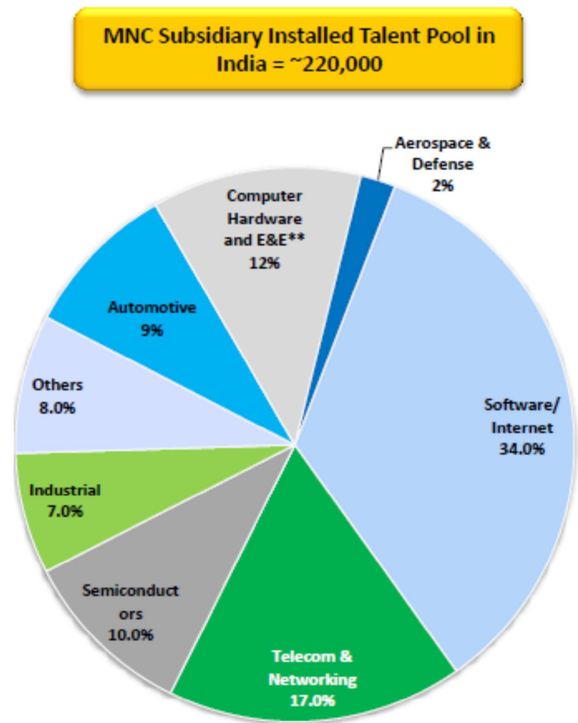
Copy to:

1. Shri N. Rangachary, Chairman of the Committee to Review Taxation of Development Centres and IT Sector. His kind attention is invited to Notes dated 12/09/2012.
2. Ms. Anita Kapur, Director General(IT), Member of the Committee.
3. Ms. Rashmi Saxena Sahni, DIT(TP), Member of the Committee.
4. Shri Dinesh Kanabar, Tax Expert, Member of the Committee.
5. Shri B.V.R. Subrahmanyam, Joint Secretary to PM.
6. PS to FM.
7. PPS to Secretary(Revenue).
8. Chairman, CBDT.

Annexure-III

India accounts for a small proportion of the total R&D investments by global companies despite having a strong talent pool across verticals





**** Electrical and Electronic equipment**

Source: Zinnov analysis of R&D Landscape in India.

CONFIDENTIAL

Fifth Report of the Committee to Review Taxation of Development Centres and the IT Sector

(Safe Harbour for Contract R&D in the Pharmaceutical Sector)

9th April, 2013

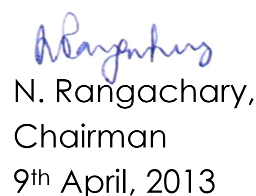
FOREWORD

The Committee had been constituted by the Prime Minister to Review Taxation of Development Centres and the IT Sector and to recommend Safe Harbour provisions for taxpayers doing business in certain sectors. The Committee has already submitted four reports to the Government and is happy to furnish its fifth report today. This report is the fourth on Safe Harbour provisions. The first report, submitted on 14th September, 2012, had addressed the taxation issues confronting the IT Sector and the Development Centres. The second report (first on Safe Harbour provisions), submitted on 13th October, 2012, had laid down the recommendations for Safe Harbour provisions for the IT-Software and ITES sectors. The third report, submitted on 18th December, 2012, had recommended Safe Harbour provisions for two areas of the financial sector, i.e., Outbound Loans and Corporate Guarantees. The fourth report was submitted on 5th April, 2013 and contained the Committee's recommendations for Safe Harbour provisions in respect of Contract R&D in the IT Sector.

This report, the fifth, contains the Committee's recommendations for Safe Harbour provisions in respect of Contract R&D in the Pharmaceutical Sector. A last report on Safe Harbour provisions for Auto Ancillaries [Original Equipment Manufacturers] would be submitted by the Committee shortly.

While furnishing this report, I must duly acknowledge the valuable contributions made by its members, namely, Ms. Anita Kapur, Member (A&J), CBDT, Ms. Rashmi Saxena Sahni, DIT (Transfer Pricing-I), Delhi and Mr. Dinesh Kanabar, Tax Expert, in examining the issues and finalizing the Committee's approach. All of them have displayed an amazing degree of commitment to the job at hand. Their intellectual inputs have enabled the Committee to finalise its recommendations.

I would also like to place on record the Committee's appreciation of the efforts put in by the three senior officers of the Department, namely Shri Subhakant Sahu, Shri D. Prabhakar Reddy and Shri Sobhan Kar, Addl. Commissioners of Income-tax, to assist the Committee in its deliberations.



N. Rangachary,
Chairman
9th April, 2013

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Fifth Report of the Committee to

Review Taxation of Development Centres and the IT Sector

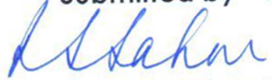
(Safe Harbour for Contract R&D in the Pharmaceuticals Sector)

Submitted by

Anita Kapur

[Member (A&J), CBDT]

Member



Rashmi Saxena Sahni

[DIT (Transfer Pricing – 1), Delhi]

Member

Dinesh Kanabar

[Tax Expert]

Member

N.Rangachary

[Former Chairman, CBDT &IRDA]

Chairman

PART-1: INTRODUCTION

1.1 Prime Minister's Office issued a press release on July 30, 2012 **(Annexure-I),** stating that the Hon'ble Prime Minister had constituted a Committee to Review Taxation of Development Centres and the IT Sector under the Chairmanship of Shri N. Rangachary, former Chairman CBDT & IRDA. The Committee submitted its first Report to the Government on 14th September, 2012 covering issues listed in the terms of reference of the Committee, except the following:

"Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector."

1.2 The rationale for entrusting the Committee with the task of finalising Safe Harbour rules was explained in the Press Release (ibid) as follows:

"As far as Safe Harbour provisions are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer"

1.3 Vide Office Memorandum dated 13th September, 2012 (**Annexure-II**), the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors / activities:

(a) IT Sector
(b) ITES Sector
(c) Contract R&D in the IT and Pharmaceutical Sector
(d) Financial Transactions – Outbound loans
(e) Financial Transactions – Corporate Guarantee
(f) Auto Ancillaries – Original Equipment Manufacturers

1.4 The Committee submitted its second report, the first on Safe Harbours, on 13th October 2012 to the Government. That report contained its recommendations for Safe Harbour rules for IT and ITES sectors.

1.5 The Committee's third report, which made recommendations for Safe Harbour rules for financial transactions of outbound loans and corporate guarantees, was submitted on 18th December 2012.

1.6 The Committee's fourth report, which contained Safe Harbour recommendations on Contract R&D in the IT Sector, has been submitted on 5th April, 2013.

1.7 This report, the Committee's fifth, contains Safe Harbour recommendations on Contract R&D in the Pharmaceutical Sector. The last report on Safe Harbour provisions for Auto Ancillaries – Original Equipment Manufacturers, would be submitted shortly.

***

PART-2: DELIBERATIONS IN THE COMMITTEE

2.1 Part 2 of the first report of the Committee on Safe Harbour provisions [the second report of the Committee] for the IT & ITES sectors included a detailed analysis of the statutory provisions regarding Safe Harbours [Section 92CB of the Income-tax Act], the need for having Safe Harbours and the opposition to the same, types of Safe Harbours, cross country transfer pricing simplification measures and existing transfer pricing simplification measures in India.

2.2 Since those concerns, analyses and explanations, in the view of the Committee, are equally relevant for this report, reference is invited to the said portion of the first report on Safe Harbours. **However, no detailed discussion on these issues is being incorporated here to avoid repetition.**

2.3 Suggestions and data to frame Safe Harbour provisions for contract R&D in the Pharmaceutical Sector were invited from the following stakeholders:

- ✓ Secretary, Department of Scientific and Industrial Research (DSIR), Ministry of Science & Technology
- ✓ Secretary, Ministry of Health and Family Welfare
- ✓ Central Board of Direct Taxes
- ✓ CII (Confederation of Indian Industry)
- ✓ FICCI (Federation of Indian Chambers of Commerce and Industry)
- ✓ ASSOCHAM (Associated Chambers of Commerce and Industry of India)
- ✓ PHDCCI (PHD Chamber of Commerce & Industry)
- ✓ ICAI (Institute of Chartered Accountants of India)
- ✓ PWC (Price Waterhouse Coopers)
- ✓ E&Y (Ernst & Young)
- ✓ Deloitte Haskins & Sells
- ✓ KPMG
- ✓ BMR Advisors

- ✓ Vaish & Associates, Delhi
- ✓ T. P. Ostwal & Associates, Mumbai
- ✓ Ranbaxy
- ✓ CIPLA
- ✓ Organisation of Pharmaceutical Producers of India (OPPI)
- ✓ Bulk Drug Manufacturers' Association
- ✓ India Pharmaceutical Alliance

2.4 Stakeholders' responses have been limited, perhaps due to the diverse products/activities profiles of the industry, as well as, business models.

2.4.1 Organisation of Pharmaceutical Producers of India (OPPI) has given general suggestions **(Annexure – III)** and has expressed concern that though the Income-tax Act was specifically amended in 2009 to provide for Safe Harbours, almost 3 years have passed since then but no Safe Harbours have been announced yet.

2.4.2 A detailed note was received from the Department of Scientific and Industrial Research [hereinafter referred to as DSIR], which is placed at **Annexure-IV.**

2.4.3 Discussions were also held by the Committee Members with Dr. K.V.S.R Rao, Scientist 'G' and Head, RDI and Dr. G.M.Bagai, Scientist 'G' from the DSIR to understand the business models prevalent in contract R&D in the Pharmaceutical sector.

2.4.4 Mr. D.G Shah, President, India Pharmaceutical Alliance [IPA] has sent a note dated 26.03.2013, which has been placed at **Annexure-V**.

2.4.5 The CBDT was requested to provide data along with comments, if any, for the consideration of the Committee. A note from DIT (TP), Ahmedabad, opposing Safe Harbour in this sector (**Annexure VI**) was forwarded by the office of DGIT (International Taxation). The focus of the said note is on manufacturing. However, the Committee has, as detailed in Part 3 of this report, recommended Safe Harbour provisions for contract R&D service providers and not manufacturers. Hence, the apprehensions expressed are not contextually relevant.

2.4.6 The Committee acknowledges all the inputs received from various stakeholders and has considered those while finalising this report.

***

PART-3: SETTING THE CONTEXT

3.1 Research and Development (R&D) is the backbone of the global leaders in the Pharmaceutical industry all over the world.

3.1.1 At the outset, it is imperative to first define the term Research and Development (R&D). As done by the Committee in its fourth report, the definition of R&D has been taken from Cambridge's Advanced Learner's Dictionary, which defines R&D as *"the part of a business that tries to find ways to improve existing products, and to develop new ones."*[1]

3.1.2 The UNCTAD's Investment Report – 2005 defines R&D as follows:

"R&D is only one component of innovation activities, but it represents the most developed, widely available, and internationally comparable statistical indicator of industrial innovation activities."

3.1.3 The report refers to an OECD study and states that R&D (also called research and experimental development) **comprises creative work "undertaken on a systematic basis in order to increase the stock of knowledge, including knowledge of man, culture and society, and the use of this stock of knowledge to devise new applications** (OECD 2002b, p. 30).

3.1.4 The report goes on to say that R&D involves novelty and the resolution of scientific and technological uncertainty. It includes basic and applied research along with development (United States, NSB 2004):

1. **Basic research.** The objective of basic research is to gain a more comprehensive knowledge or understanding of the subject under study without specific applications in mind. In industry, basic research is defined

[1] Cambridge's Advanced Learner's Dictionary - http://dictionary.cambridge.org/dictionary/british/re-search-and-de-velopment

as research that advances scientific knowledge but does not have specific immediate commercial objectives.

2. **Applied research.** The objective of applied research is to gain the knowledge or understanding to meet a specific, recognized need. In industry, applied research includes investigations to discover new scientific knowledge that has specific commercial objectives with respect to products, processes, or services.

3. **Development.** Development is the systematic use of the knowledge or understanding gained from research directed towards the production of useful materials, devices, systems or methods, including the design and development of prototypes and processes.

3.1.5 It further states that for data collection purposes, the boundary between R&D and other technological innovation activities can be found in pre-production development activities (OECD 2002b). In practice, however, it is difficult to make the distinction. In technology-intensive industries distinguishing between "research" and "development" is especially difficult since much of the R&D work conducted involves close interaction between researchers in both the private and public sectors, often also including close collaboration with customers and suppliers (BIAC2005, Amsden and Tschang 2003).

3.1.6 According to the report of the Working Group on Pharmaceuticals – 12th Five Year Plan (2012-17) – Planning Commission (hereinafter referred to as Working Group on Pharma), -

- The global average R&D expenditure in 2010 was $68 billion which was around 8% of global Pharmaceutical sales in 2010 i.e., $856 billion.
- Although the Indian Pharmaceutical industry is large by Indian standards, its share in the world market is merely 2.4%. The estimated investment in R&D by

major Indian Pharma companies is around 8.68% of their sales turnover. As a percentage of total production, this works out to only 4.4% of the same.

- With many of the blockbuster drugs getting off-patented and with increasing R&D costs, it is hard for the global companies to maintain bottom-lines. Hence, they are taking recourse to outsourcing some of their research and manufacturing activities to low-cost countries and saving on costs in the process.
- Outsourcing has led to the growth of Contract Research and Manufacturing Services or CRAMS.
- Business of CRAMS has come as a boon to the mid-cap Pharmaceutical companies in India as India could potentially capture 10% of the global CRAMS market of almost US$ 200 billion by 2026. Overall, the CRAMS segment is expected to grow 30-35% per annum on top of a growth of 40-50% in the last few years.

3.1.7 Thus, India has tremendous potential as a destination for outsourcing of R&D in Pharmaceuticals Sector. In this context, DSIR[2] has the following view on the state of the Pharmaceutical industry in India:

Quote

India is emerging as a favourable country for research and collaboration to provide solutions through cost effective competitiveness and innovative capabilities. India is a hub for outsourcing research and manufacturing. A recent report from Frost & Sullivan suggested that the combined value of the Indian & Chinese market for outsourced R&D was around US$7 billion and could rise to US$ 19.8bn by 2011.

Unquote

[2] "Pharmaceutical R&D in India", a note received from Dr K.V.S.R Rao, Scientist 'G' and Head, RDI and Dr. G.M. Bagai, Scientist 'G', Department of Scientific & Industrial Research, on 21/01/2013.

3.1.8 Reji K Joseph[3], in his research thesis, has described the R&D Scenario in Indian Pharmaceutical Industry as follows:

- The policy initiated since the mid-1990s has opened the doors for the globalisation of Indian pharmaceutical industry.
- Indian pharmaceutical firms are now part of the global R&D and production network of MNCs. In other words they have become partners to the non-equity modes of international production and development[4].
- With globalisation, the focus of Indian pharmaceutical firms has shifted away from the domestic market and has got aligned with the R&D strategies of MNCs.
- The orientation of Indian firms has also changed from that of competitors in the earlier policy regime to that of collaborators of a subordinate order in the new regime.

3.1.9 He further states that Pharmaceutical industry is an R&D intensive sector. R&D intensity (R&D expenditure as a % of sales) in the sector has grown from 1% in 1994 -95 to 5% in 2009-10 (R&D expenditure is the sum total of R&D capital and current expenditures). However, the expenditure on advertisement and marketing is much more than that on R&D, as illustrated below:

Investment of Indian Pharmaceutical Industry in R&D and Advertising & Marketing (% of sales)		
Year	**R & D**	**Advertising & Marketing**
2000-01	2.0	5.9
2001-02	2.4	5.8
2002-03	2.7	6.2
2003-04	3.4	6.2
2004-05	4.7	6.2
2005-06	5.2	5.8

[3] Joseph, Reji K., The R&D Scenario in Indian Pharmaceutical Industry, RIS Discussion Paper #176, Research and Information System for Developing Countries (RIS) – Page 116.
[4] The theme of the World Investment Report 2011 is 'non-equity modes of international production and development'.

2006-07	4.8	5.6
2007-08	4.6	5.5
2008-09	4.8	6.0
2009-10	4.6	5.4
Source: CMIE		

3.2 In terms of value chain, contract research in India consists of wide spectrum of Pharmaceutical and Biological research and development value chain. For example, in the drug discovery value chain, there are key blocks like Biology, Chemistry, drug evaluation, pre-clinical trials and clinical trials. Various segments of the R&D value chain (Reference - Note from DSIR **[Annexure IV]**) are briefly described below:

- **Biologicals / Biotechnology:**– This value chain of the segment deals with vaccine development, diagnostic kits, birth control measures, novel recombinant technologies for bio-catalysis and fermentation, new biotechnology processes (bio-conversion) for production of semi-synthetic antibiotics, enzymes and hormones for use in healthcare, regenerative medicines for biological material research, stem cell biology to molecular imaging and tissue engineering.

- **Clinical Research**:- Clinical trials are sets of tests in medical research and drug development that generate safety and efficacy data and, more specifically, information about adverse drug reactions and adverse effects of other treatments for any new drug to be launched in the health sector.

- **Natural Products**:- R&D requires the researcher to isolate, purify and characterise phytocompounds from different medicinal plants for use as reference substances in chromatography. These R&D services also identify herbs with therapeutic value, perform pharmacological assays and clinical trials of natural product extracts, develop or upgrade formulations and develop nutraceuticals and health supplements.

- **New Drug Discovery**:- Development of New Chemical Entities (NCE), i.e, compounds, which have not previously been described in scientific literature and are responsible for the physiological or pharmacological action that could translate into a drug after clinical trials.

- **Generics R&D**:- Most of the Indian Pharmaceutical companies are into Generic drug manufacturing. Generic drugs are copies of brand name drugs and are the same as those brand name drugs in dosage form, safety, strength, route of administration, quality, performance characteristics and intended use. However, they can develop new salts, esters of existing ingredients or chemical derivatives of active ingredients. Generic drugs can be produced without patent infringement for drugs where:
  - ✓ the patent has expired,
  - ✓ the generic company certifies that the brand company's patents are either invalid, unenforceable or will not be infringed,
  - ✓ the drugs have never held patents, or
  - ✓ the drugs do not have current patent protection in a country.

Patent lifetime differs from country to country; typically an expired patent cannot be renewed[5].

- **Formulation Development:**– The efficacy of Generic drug formulation must meet the quality standards of branded drugs. During formulation, scientists compare their recipe with the innovator drug to ensure it has a very close profile without impurities. The U.S. Food and Drug Administration (US FDA) require bioequivalence to be between 80% and 125% of the innovator

[5] MNCs do attempt 'evergreening' of patents through the legal process, e.g. the recent case of Novartis, which was not accepted by the Supreme Court of India.

product. High quality, technology driven product development is carried out to produce a stable and clinically safe and effective formulation.

- **Process Development**:– The research focus is on developing new processes and improving yields of tailor-made Active Pharmaceutical Ingredients (APIs). The development of practically robust and cost effective processes for the synthesis of APIs has critical implications for subsequent manufacturing and commercialization of Generics by gaining process patents. R&D is to be supported by a Kilo Lab to scale up the flask technology to a reasonable scale.

- **Novel drug delivery systems**:- This segment of value chain in research is for developing novel effective systems for delivering the drugs in the body, new dosage forms for patient compliance and to overcome resistance/side effects, sustained release of the drug in the body or improvise the existing technologies to enhance drug efficiency and packaging development for improved storage and reduced contamination.

- **Custom synthesis:-** Create scalable, robust and cost-effective synthesis processes across multiple chemistry and therapeutic categories by in-house analytical capabilities and quality manufacturing assets. These R&D centres provide innovative route scouting, process R&D and rapid-response custom synthesis of regulatory starting materials, advanced intermediates and APIs for pre-clinical – Phase III clinical studies.

- **Physiochemical Characterization of molecules:-** Drug Metabolism and Pharmacokinetic (DMPK) and bio-analytical ADME services, such as, drug solubility, stability, excretion, permeability, CYP inhibition, protein binding within human/animal system to advance discovery and pre-clinical drug development activities.

- **Animal toxicology studies:-** These R&D services offer Good Laboratory Practice (GLP) - compliance regulatory toxicology studies for Investigational New Drug (IND) application as well as non-GLP pharmacology and toxicology studies in order to provide preliminary assessment of a drug's safety and toxicity. A comprehensive range of studies in general and reproductive toxicology, carcinogenicity and safety pharmacology are available.

3.2.1 The Pharma sector is capital intensive with generally long gestation periods, as well as, characterised by uncertainty of results. The return on investment is neither quick nor certain, thereby involving high degree of risk. The business model is also variable. In quite a few cases, it could be a cost sharing arrangement and profit may be split according to an agreement. This is an industry where contracts and R& D intangibles (R&D investment is the input, the output for which may, in a successful research, physically manifest as patents) play a key role. Generally, cost of development of a patent and its value has no correlation and deducing income therefrom is a difficult task. However, ascribing a financial value to a patent may be relatively easier in an identified product in this industry.

3.2.2 The industry in India is characterised by low cost of research, leading to location savings when outsourcing R&D to India. According to DSIR, [6] "Based on the assumption that relevant global R&D spending is perhaps close to 60 billion dollars with a split of 33:66 in the non-clinical to clinical spend level, and current trends indicating that the fully-loaded cost of operations in India is 1/3rd and 1/5th of costs in the US and Western Europe for non-clinical and clinical operations respectively, the global R&D spend at Indian prices works out to approximately 15 billion dollars."

[6] "Pharmaceutical R&D in India", a note received from Dr K.V.S.R Rao, Scientist 'G' and Head, RDI and Dr. G.M. Bagai, Scientist 'G', Department of Scientific & Industrial Research, on 21/01/2013.

3.2.3 R&D in this sector is obviously multi-dimensional and covers a wide spectrum as already discussed in para 3.2. Further, R&D could be basic – fundamental or applied.

3.2.4 All these different activities within Pharma R&D would require different approaches depending on the functional profile of the entity involved. Formulating a Safe Harbour for such a diversified industry is a challenge. In his note, Mr. D.G. Shah, President, India Pharmaceutical Alliance has highlighted the following features of R&D in India (**Annexure V**):

Quote:

It is pertinent to note that R&D intensity of pharmaceutical industry is unique. It takes about four years and $2 mn to bring a generic to market. The current estimate by the Indian companies to bring a new molecule to market is 10 years and $ 200mn.

The in-house R&D is used for competitive edge in the global markets. However, as the pharmaceutical R&D is prolonged and risky, the companies out license their work at various stages of development. The risk at the early stage of development is higher and hence realization is lower. On the other hand, as the product/process moves forward successfully on the development path, the risk for the licensee is lower and hence realization is better.

Unquote

3.2.5 After considering all the inputs available, the Committee notes that there are essentially the following three types of business models for conducting R&D in this sector:

- Contract Research and Manufacturing Services (CRAMS) – **Contract agreements**
- Collaborative Research Projects – **Cost contribution / revenue sharing agreements / sharing the rights in developed drug**
- Out–licensing and in-licensing – **Full fledged entrepreneurial model**

3.2.6 According to DSIR, "India has raised its technology capability through reverse engineering but lagged behind in developing skills to support discovery-oriented innovative research. Hence, collaborative research partnership with large and mid-sized pharma companies is a new business model selected by Indian R&D units."

3.2.7 In the light of the above discussion, the Committee is of the view that only some of the R&D activities under CRAMs can be considered for Safe Harbour.

3.2.8 Further, the Committee also took note of competitive advantage of India in each of the segments of R&D as described above. India's strength in pharma mainly lies in APIs and Generics as we have the capabilities of reverse engineering of off-patented APIs and off-patented branded drugs. India's traditional strength lies in small molecule APIs and Generics and it is imperative to define the terms Generic and Active Pharmaceutical Ingredient (API). As the Committee could not locate any definition under the Indian statutes / regulations of Generics and Active Pharmaceutical Ingredients (APIs), the definitions have been borrowed from the U.S Food and Drug Administration (US FDA) and World Health Organisation (WHO).

3.2.9 The definitions adopted by the Committee are as follows:

3.2.9.1 The term '**Generic'** may be defined as a drug product that is comparable to a brand/reference listed drug product in dosage form, strength,

route of administration, quality and performance characteristics, and intended use (US FDA).

3.2.9.2 The term **'Active Pharmaceutical Ingredient (API)'** may be defined as any substance or mixture of substances intended to be used in the manufacture of a drug product and that, when used in the production of a drug, becomes an active ingredient in the drug product. Such substances are intended to furnish pharmacological activity or other direct effect in the diagnosis, cure, mitigation, treatment or prevention of disease or to affect the structure and function of the body (US FDA). Alternately, it may be defined as a substance used in a Finished Pharmaceutical Product (FPP), intended to furnish pharmacological activity or to otherwise have direct effect in the diagnosis, cure, mitigation, treatment or prevention of disease, or to have direct effect in restoring, correcting or modifying physiological functions in human beings (WHO).

3.2.10 Currently, other terms are also used by the industry to mean an API. For example, "Drug substance", "drug intermediary", "active component" and "bulk drug" are terms commonly used to mean an API. The use of these terms to describe APIs may be considered equivalent to the term API.

3.2.11 India ranks third in worldwide volume of production and is 14th largest by value. The main reason for this discrepancy has been determined to be the lower cost of such drugs in India, compared not only to the traditional markets but also to smaller markets like Zimbabwe and Sri Lanka. An important characteristic of the Indian pharma industry is its exports and this is sustained by the increasing competitiveness of the industry vis-à-vis the developed and regulated markets. This is reflected in the large number of Abbreviated New Drug Applications (ANDA) for Generics and First to File (FTF) fillings for the formulations sector (New Drugs) and Drug Master Files (DMF) filings for the bulk drugs or APIs by Indian companies in the U.S Food & Drug Administration (US

FDA) for exports to US market. Such exports are valued at US $ 300 Billion in 2009. In 2010, over 30% of DMF approvals by US FDA were from India. It is noteworthy that this proportion of filings by Indian companies has increased from 14% in 2000 [7] . This shows the competitiveness of the Indian Pharma industry as compared to the other leading generics producers like China, Israel and Germany. In fact, all the top 10 Generic Players of the world have presence in India and these companies are also among the top spenders on R&D in APIs. The list of these players is given below:

Top-10 Global Generic Players [8]

Rank	Company
1	Teva
2	Sandoz
3	Mylan/Merck GX
4	Watson Andrx
5	Barr
6	Actavis
7	Ratiopharm
8	Stada
9	Ranbaxy
10	Perrigo

3.2.12 It is further noticed by the Committee that there are many Indian companies that are engaged in rendering R&D services in APIs and Generics. List of Indian entities doing research in APIs and generic drugs [9] is placed at **Annexure VII**.

3.3 In view of the above discussion, it is obvious that there is an inherent complexity and diversity within the sector requiring voluminous and quality data of various kinds for analyses to understand the sector. **It is the view of the**

[7] Working Group on Pharmaceutical – Planning Commission – 12th Five Year Plan (2012-17) – Page 25 & 26
[8] Ibid, Page 53.
[9] Joseph, Reji K., The R&D Scenario in Indian Pharmaceutical Industry, RIS Discussion Paper #176, Research and Information System for Developing Countries (RIS).

Committee that Safe Harbour can be recommended for enterprises with insignificant risks and undertaking mainly API / generic research and development services. The terms Generics and APIs have already been defined at Para 3.2.9.1 and 3.2.9.2 respectively.

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PART-4: RECOMMENDATIONS – SAFE HARBOUR FOR CONTRACT R&D IN THE PHARMACEUTICAL SECTOR

4.1 The Committee recommends that Safe Harbour provisions should be applicable to enterprises engaged in contract R&D in the Pharmaceutical sector. An enterprise eligible for Safe Harbour may be called an 'Eligible Enterprise' and all the transactions that are eligible for Safe Harbour may be called 'Eligible International Transactions'.

4.2 The Committee recommends that the Government may consider the following while framing Safe Harbour Rules for Eligible Enterprises opting for Safe Harbour in contract R&D services in the Pharmaceutical sector.

4.3 **General Recommendations**

- The taxpayer should have the option of whether to go in for Safe Harbour or not and it should not be mandatory. However, Safe Harbour should not become a rebuttable presumption for an assessee who opts not to go for it and has an Arm's Length Price [ALP] below the Safe Harbour. There has to be a directive to the Assessing Officer/TPO in this regard that they can get the international transactions benchmarked but cannot force the assessee to rebut the presumed ALP.
- Safe Harbour would not be available to an assessee whose profits are higher than the Safe Harbour margins on account of its contracted price and such an assessee cannot be assessed at the lower presumptive ALP corresponding to the Safe Harbour.
- Safe Harbour margins recommended may be made applicable from A.Y 2013-14, for a period of two years.

- Further, an institutional mechanism needs to be evolved so that every two to three years, the Safe Harbour rules/margins/rates are reviewed and notified in advance so that the taxpayers can comply with such provisions with ease.
- If any other international transaction is otherwise eligible for Safe Harbours, for example, loan or corporate guarantee, it will continue to be an Eligible International Transaction for the purposes of Safe Harbour.
- Safe Harbour provisions may not be applicable if the Eligible Enterprise renders services in the nature of Eligible International Transactions to any Associated Enterprises (AE) located in jurisdiction as notified under section 94A of the Act or any other country/territory widely perceived as a tax haven.

4.4 Recommendations on threshold

4.4.1 The existing limit of Rs. 1 crore provided under sub-rule 2 of Rule 10D was fixed more than a decade ago. There is a need for upward revision as also a need to adjust for inflation. It may be mentioned that change in monetary parameters on account of inflation factor is part of our tax policy as is evident from the fact that the monetary limit for audit of accounts of certain persons engaged in business, as provided in section 44AB of Income Tax itself, has been revised upwards from Rs. 40 lakhs to Rs. 1 crore during the corresponding period.

4.4.2 Accordingly, the Committee recommends that the exemption from maintaining information and documentation for international transactions specified at Rs. 1 crore under sub-rule 2 of Rule 10D of the Income-tax Rules be raised to Rs 5 crore as it will reduce compliance cost for small assessees. Tax administration will have a smaller basket for picking up cases for scrutiny facilitating optimum use of its resources.

4.4.3 The present practice of authorising the AO to do transfer pricing audit in select number of cases, where the aggregate value of international transactions is less than the threshold limit (Rs. 15 crore), has reduced the applicability of the threshold limit as a Safe Harbour while simultaneously diluting the effectiveness of transfer pricing audit. **The Committee, therefore, recommends that the threshold of Rs.15 crore as an administrative Safe Harbour should be specified as a statutory Safe Harbour rule itself.**

4.5 Specific Recommendations

4.5.1 The Committee recommends that the 'Eligible International Transaction' shall be the rendering of contract R&D services, partly or fully, in relation to APIs and Generics alone, in the Pharmaceutical Sector by the 'Eligible Enterprise'.

4.5.2 Further, the Committee recommends that an 'Eligible Enterprise' shall be an enterprise carrying out contract R&D, partly or fully, in Generics and APIs in the Pharmaceutical Sector, with insignificant risks. In the view of the Committee, Safe Harbours may be considered only for these enterprises. In other cases, where there is a cost sharing or cost contribution arrangement (CCA) or entrepreneurial activity, appropriate FAR analysis needs to be done on a case specific basis, and hence, no Safe Harbours are recommended for such entities.

4.5.3 The Safe Harbours recommended in this report would be applicable to an Eligible Enterprise that meets the following conditions, cumulatively, so as to be treated as a Contract R&D service provider with insignificant risk and the most appropriate method in such cases would be the Transactional Net Margin Method (TNMM) with an applicable mark-up as suggested by the Committee. (the conditions mentioned below are in accordance with the broad principles enunciated by the Committee in Para 2.15.3 of its first report):

- The critical functions with regard to R&D Services, for the product or processes are driven by the foreign principal.

- The principal provides funds/capital for such Services. The principal bears the risk of failure of the research and development and will be the owner of the outcome of such R&D and also any intangible generated in rendering such R&D services, while the Eligible Enterprise is allocated a guaranteed remuneration on services pertaining to Eligible International Transactions, irrespective of whether the outcome of such R&D is a success or a failure.

- The Eligible Enterprise is required to report back to the principal on a regular basis, e.g. at predetermined milestones. The principal is expected to be able to assess the outcome of the R&D activities. Any suggestion to the modification of R&D programme by the Eligible Enterprise is subject to the review and approval by the foreign principal who makes the relevant decisions to control the risks.

- The Eligible Enterprise, in respect of R&D services pertaining to Eligible International Transactions, does not assume risks or has insignificant realised risk such as market risk, business risks, economic conditions risk, credit & collection risk, capacity utilisation risk, quality risk, product/process / service acceptance risk, product/process development risk, infrastructure utilisation risk, intellectual property infringement risk.

- The Eligible Enterprise, as contract R&D service provider, has no right to ownership on the outcome of any intangible generated or arising during the course of rendering such R&D services. The rights in the developments contractually vest since inception with the foreign principal and the registration of any IP arising from such development is made by the foreign principal. Involvement of the Indian personnel to comply with filing requirements, without any underlying rights in the exploitation by the Indian

personnel and / or by the Eligible Enterprise, is evident from the employee contract and / or contract between Eligible Enterprise and its foreign principal.

- The patent, if any, whether registered or not, cannot be commercially exploited on a standalone basis and its contribution to the overall value chain is indeterminate.
- The terms and conditions regarding ownership of intangibles would have been similar if the R&D activities carried on by the Eligible Enterprise were or could have been outsourced to a third party.

4.5.4 Margin for Safe Harbour and Most appropriate method

4.5.4.1 The Department has submitted data on the value of international transactions, margins shown by the assessees and the margins adopted by the TPOs for transfer pricing cases involving R&D services in Pharmaceutical sector. It is observed from this data that the taxpayers are engaged in various facets of R&D services like clinical research, new drug discovery, API, Generics etc. So, this data does not reflect margins attributable to only R&D in Generics and APIs. The sample size is also relatively small. Despite this limitation of the data provided by the Department, in the absence of any other data more robust than this, the Committee has no alternative but to use this data for arriving at Safe Harbour margins. The data submitted by the Department is summarised as below (details at **Annexure VIII**):

Assessment Year	Average Margins shown by the assessee (PLI in %)	Average Margins adopted by the TPO (PLI in %)
2006-07	17.75	33.24
2007-08	13.15	30.33
2008-09	14.60	25.37

2009-10	**11.72**	**21.58**
Arithmetical Mean	**14.31**	**27.63**

4.5.4.2 There is a view within the Committee that Safe Harbour margins must recognise the following factors, which support outsourcing of R&D activities to India:

- The captive DC conducting research provides a competitive advantage to its parent in terms of costs and professional competence arising due to locational advantage. India has unique location-specific intangibles such as skilled workforce, connectivity facilities and lower costs.
- In addition to the above, the issue of market premium also needs to be factored in.

4.5.4.3 An alternate view within the Committee is that market premium or location savings need not be factored in. The comparables chosen for the purposes of evaluation of whether the pricing is at arm's length operate in the same location and enjoy the same market premium or location savings as are enjoyed by the Indian captive service providers. As such, once an arm's length price is worked out and is factored in, evolving a safe harbour, there is no question of incremental factoring in of market premium or location savings.

4.6 In view of all the factors discussed in the earlier paragraphs of the report, the Committee is of the view that Transactional Net Margin Method (TNMM) is the most appropriate method in the case of contract R&D service providers with insignificant risks. The Operating Profit on Operating Expenses is considered as the appropriate PLI for Safe Harbour under TNMM.

4.6.1 The Committee noted that the data available with the Department pertains to Assessment Years 2006-07 to 2009-10 wherein TPOs have made adjustments to arrive at the Arm's Length Price [ALP]. The average margin of

these 4 years is 27.63%. The Committee also noticed that there has been a consistent downward movement of the margins over these 4 years and the margin for the latest year, i.e., 2009-10, is 21.58%. Taking into consideration all the facts and also that the TPOs' orders have not attained finality, the Committee recommends 29% as an all-inclusive Safe Harbour margin.

4.6.2 The Committee understands that for computing the above-recommended **29%** margin, the method of computing the Profit Level Indicator (PLI) is of critical importance. Operating Profit Margin is the most crucial aspect for calculating the PLI. **Accordingly, the Committee recommends that "Operating Expense", "Operating Revenue" and "Operating Profit" for the purposes of calculating PLI should be defined as follows**:

- "**Operating Expense"** is the expense of the Eligible Enterprise incurred during the course of its normal operations and in connection with Eligible International Transactions for the previous year, including depreciation / amortization expenses relating to assets used by the Eligible Enterprise but excluding interest expense, provisions for unascertained liabilities, pre-operative expenses, the loss arising out of translations of foreign currency items, extraordinary and other items not relating to the operating activities of the Eligible Enterprise for the previous year, the loss on sale of assets / investments of the company, and the effects relating to the income tax expense of the company.
- "**Operating Revenue**" is the revenue of the Eligible Enterprise earned in connection with Eligible International Transactions and during the course of its normal operations for the previous year, but excluding interest income, the income arising out of translations of foreign currency items, the income on sale of assets or investments of the company, the refunds relating to the income tax expense of the company, provisions no longer required written

back and extraordinary and other items not relating to the operating activities of the Eligible Enterprise for the previous year.

- "**Operating Profit**" is the profit earned from normal operations of the Eligible Enterprise. It is computed as the operating revenue of the Eligible Enterprise less the operating cost incurred for an accounting period.

4.6.3 If an Eligible Enterprise is into multiple activities other than Eligible International Transactions (contract R&D in pharma – Generics / API), then a certificate from the auditor may be prescribed to audit and certify the profitability arising under TNMM on account of the Eligible International Transaction.

4.6.4 Accounting terms used in these Rules shall be defined in accordance with generally accepted financial accounting principles in India.

4.6.5 **The Committee recommends that once Safe Harbour rules are opted for by an assessee, no margin variation benefit under section 92C(2) or any other comparability adjustment such as, capacity, risk, working capital, etc. would be permitted**.

4.6.6 To reduce compliance costs for the assessees, it is imperative that the documentation burden on the taxpayers opting for Safe Harbour is made less stringent, as compared to an assessee choosing regular TP documentation and scrutiny by the Department. Accordingly, the Committee recommends that such an enterprise need not maintain information and documents specified in clauses (g) to (m) of Rule 10D(1) in respect of the Eligible International Transactions.

4.6.7 The Committee clarifies that Safe Harbour rules would not give immunity from scrutiny of any international transactions other than the Eligible

International Transactions that have been opted by the Eligible Enterprise to be covered under Safe Harbour.

4.7 Recommendations on Procedural /Administrative Issues.

4.7.1 An Eligible Enterprise may exercise its option for accepting the Safe Harbour for the year by filing an option form with the Assessing Officer not later than the due date for filing the Income-tax return. If necessary a new Statutory Form for exercising Safe Harbour option to be filed along with return of income may be prescribed. Alternately, the 3CEB Report should be modified to provide for indication of election of Safe Harbour option for the year along with identification of Eligible International Transactions.

4.7.2 The Committee recommends that the AO must compulsorily refer such cases to the TPO who will conduct the functional analysis to determine the Eligible Enterprise as well as the Eligible International Transaction before accepting the results of the taxpayer under Safe Harbour. Besides, there should be strict penalties if any of the eligible conditions laid down for Safe Harbour are violated by the taxpayer.

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Annexure-I

PM sets up committee to review Taxation of Development Centres and the IT Sector, Safe Harbour Provisions to be Finalised soon

July 30, 2012
New Delhi

The Prime Minister has constituted a Committee to Review Taxation of Development Centres and the IT Sector. The Committee will engage in consultations with stakeholders and related government departments to **finalise the Safe Harbour provisions** announced in Budget 2010 sector-by-sector. It will also suggest the approach to **taxation of Development Centres.**

2. The Prime Minister had earlier set up an Expert Committee on GAAR under the Chairmanship of Dr. Partho Shome to engage in a widespread consultation process and finalise the GAAR Guidelines. The response has been overwhelmingly positive.

3. While this committee would address concerns on GAAR provisions and would reassure investors about the predictability and fairness of our tax regime, it was felt that there is still a need to address some other issues relating to the taxation of the IT Sector such as the approach to taxation of Development Centres, tax treatment of "onsite services" of domestic software firms, and also the issue of finalising the Safe Harbour provisions announced in Budget 2010.

4. Many MNCs carry out activities such as product development, analytical work, software development, etc. through captive entities in India. They exist in a wide range of fields including IT software, IT hardware, Pharmaceutical R&D, other automobile R&D and scientific R&D. These are popularly called **Development Centres**. Over 750 MNCs have such centres at over 1100 locations in India. The reason for this large concentration of Development Centres in India is the worldwide recognition of India as a place for cost competitive, high quality knowledge related work. Such Development Centres provide high quality jobs to our scientists, and indeed make India a global hub for such Knowledge Centres. However, India does not have a monopoly on Development Centres. This is a highly competitive field with other countries wanting to grab a share of the pie. There is need for clarity on their taxation.

5. As far as **Safe Harbour provisions** are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer.

6. The resolution of the above tax issues requires a comprehensive approach in which other government departments are consulted and industry bodies are taken on board. The overall goal is to have a fair tax system in line with best international practice which will promote India's software industry and promote India as a destination for investment and for establishment of Development Centres. Therefore, the Prime Minister has constituted a Committee consisting of experts from the Income Tax Department, both serving and retired, who will examine the issues in detail and submit proposals in a short time. An arm’s length exercise of this nature will allay a lot of concerns in addition

to the immediate resolution of issues that is necessary.

7. For this purpose, a **Committee on Taxation of Development Centres and the IT sector** has been constituted consisting of:

1) Shri N. Rangachary, former Chairman CBDT & IRDA - Chairman

2) Ms Anita Kapur, Director General (IT) - Member

3) Ms Rashmi Sahani Saxena, DIT (TP) - Member

4) Any other officer from the Income Tax Department to be co-opted by the Chairman

8. The **Terms of Reference of the Committee** will be to:

i) Engage in consultations with stakeholders and related government departments to finalise the approach to Taxation of Development Centres and suggest any circulars that need to be issued.

ii) Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector. The Committee will also suggest any necessary circulars that may need to be issued.

iii) Examine issues relating to taxation of the IT sector and suggest any clarifications that may be required.

9. The Committee will work to the following time schedule:

i) Finalise the approach to taxation of Development Centres and suggest any necessary clarifications by **31 August 2012.**

ii) Suggest any necessary clarifications that may be needed to remove ambiguity and improve clarity on taxation of the IT Sector by **31 August 2012.**

iii) Finalise Safe Harbour Rules individually sector-by-sector in a staggered manner and submitting draft Safe Harbour provisions for three sectors/sub-activities each month beginning with the first set of suggestions **by 30 September 2012.** All Safe Harbour provisions can be finalised by **31 December 2012.**

10. The Department of Revenue will provide all necessary support to the Committee to facilitate its work including office assistance and assistance to facilitate consultations.

Annexure- II

F.No.A. 50050/103/2012-Ad.I
Government of India
Ministry of Finance
Department of Revenue
***

New Delhi, dated the 13th September, 2012.

OFFICE MEMORANDUM

Subject: Constitution of a Committee to Review Taxation of Development Centres and the IT Sector- Reg.

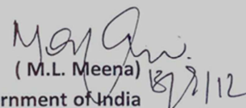
***

The undersigned is directed to refer to Department of Revenue's O.M. of even number dated 3rd August, 2012 on the above cited subject and to say that considering the paucity of adequate data required to draft the rules, the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors/activities:

(i) IT Sector
(ii) ITES Sector
(iii) Contract R&D in the IT and Pharmaceuticals Sector
(iv) Financial Transactions – Outbound loans
(v) Financial Transactions – Corporate Guarantee
(vi) Auto Ancillaries – Original Equipment Manufacturers

2. In view of the above, the revised timelines for submitting the reports on Safe Harbour provisions by the Committee have been modified as under:

First Report by 15.10.2012;
Second Report by 15.11.2012; and
Final Report by 31.12.2012.



(M.L. Meena)
Joint Secretary to the Government of India

Copy to:

1. Shri N. Rangachary, Chairman of the Committee to Review Taxation of Development Centres and IT Sector. His kind attention is invited to Notes dated 12/09/2012.
2. Ms. Anita Kapur, Director General(IT), Member of the Committee.
3. Ms. Rashmi Saxena Sahni, DIT(TP), Member of the Committee.
4. Shri Dinesh Kanabar, Tax Expert, Member of the Committee.
5. Shri B.V.R. Subrahmanyam, Joint Secretary to PM.
6. PS to FM.
7. PPS to Secretary(Revenue).
8. Chairman, CBDT.

Annexure-III

ORGANISATION OF PHARMACEUTICAL PRODUCERS OF INDIA
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Telephone: 91 + 22 + 2491 8123, 2491 2486, 6662 7007 Fax: 91 + 22 + 2491 5168
Email: indiaoppi@vsnl.com Website: www.indiaoppi.com

OPPI Comments with reference to Safe Harbour

Safe Harbor	Comments / Suggestions
Safe Harbour Safe Harbour has been defined to mean 'circumstances' in which the revenue authorities shall accept the transfer pricing declared by the taxpayer. Internationally used safe harbours take two forms – • Exclusion of certain classes of transactions based on quantitative limits from Transfer Pricing regulations. • Stipulation of margins / thresholds for prescribed classes of transactions / specified industries The Income Tax Act was specifically amended in 2009 to provide Safe Harbours to be formulated by the CBDT. Even though almost 3 years have passed since then, no Safe Harbours have been announced yet.	Specific Safe Harbour Rules should be notified to ease the compliance burden on taxpayers, curtail disputes and reduce administrative hassles for both, the taxpayers and the taxmen. This is especially critical for development centres in India in this industry. While making these rules, the CBDT should consider simplification measures involving Comparable Profits Method (CPM) and Comparable Uncontrolled Price (CUP) method. Safe Harbours for interest rates on borrowings and lending, reimbursement and recovery of expenses, would be a salutary simplification measure. Such Safe Harbour may benefit large number of taxpayers but revenue implication may not be significant. Similarly, captive clinical trial services can be covered by Safe Harbour provisions. The Safe Harbour Rules in India can be framed keeping in view the national considerations and the most litigated and disputed aspects. Simplification measures might help in reducing the cost of maintaining detailed documentation for the taxpayers and reduce administrative and litigation costs for both the revenue and the taxpayer. It will also help the revenue to focus more on the bigger and more risky transactions in the interest of revenue.

Annexure-IV

Note received from the Department of Scientific and Industrial Research

Pharmaceutical R&D in India

Scenario in India:

In 1970 laws and policies were made to regulate Indian Pharmaceutical Industry and counteract monopoly of foreign multinationals. Indian Patent act of 1970 propelled reverse engineering based R&D or imitative pharma industry with focus on domestic market. Changes in patent law under TRIPS obligation in 2005 in compliance with the global practices prevented reverse engineering and forced Indian firms to enhance their R & D efforts and investments.

The global pharmaceutical industry is going through a tough time as pipeline of new drugs in making is drying fast due to high failure rate in drug discovery, spiralling cost of research and limited cash. However India is emerging as a favourable country for research and collaboration to provide solutions through cost effective competitiveness and innovative capabilities. India is a hub for outsourcing research and manufacturing. A recent report from Frost & Sullivan suggested that the combined value of the Indian & Chinese market for outsourced R&D was around US$7 billion and could rise to US$ 19.8bn by 2011.

Pharmaceutical companies have started relying on Indian CROs for their chemistry, formulations and clinical development. The Indian biotechnology sector is one of the fastest growing knowledge-based sectors in India and is expected to play a key role in shaping India's rapidly developing economy. The Indian biotech industry grew threefold in just five years to report revenues of US$3 billion in 2009-10, a rise of 17 per cent over the previous year.

In general we may say, Companies engaged in carrying out research and manufacture of chemicals which need to be licensed for marketing as pharmaceuticals under the Drugs and Cosmetics Act, 1956 and amendments thereof are categorized under pharmaceuticals industry. Pharmaceuticals include chemicals, biologicals (Vaccines) and Sera, Ayurvadic drugs and chemicals produced through fermentation route), formulations including additives and in-plants for human and veterinary use.

The term API is used for Active Chemical ingredients used in pharmaceuticals subsequent to patent expiry. The term NCE (New Chemical Entity) is used in the investigation stages before the companies are licensed by a regulatory authority to use the chemical as a pharmaceutical. Generic drugs are basically pharmaceuticals formulated using APIs.

Focus Areas:

Over the past few years entrepreneurs in India have developed capabilities across a wide spectrum of the pharmaceutical and biological research and development value chain such as:

Biologicals/Biotechnology – Indian Biotech companies have diversified and are venturing into varied biotechnology based products such as vaccine development, diagnostic kits, birth control measures, novel recombinant Protein Expression and transfection technologies for bio-catalysis and fermentation, new biotechnology processes (bio conversion) for production of semi-synthetic antibiotics and enzymes and hormones of use in health care. Other R&D areas are Regenerative medicines for biological material research, stem cell biology to molecular imaging and tissue engineering.

There are about 100 biopharmaceutical companies actively involved in research and development, manufacturing and marketing of biologics in India. Currently, 20 recombinant therapeutics are approved by the Genetic Engineering Approval Committee (GEAC) for marketing in India. Leading therapeutic products are, Erthropoietin available in with 55 brands, chorionic gonadotropin available in 48 brands, streptokinase has 33 brands, and both interferon and heparins are sold under 10 brands each.

Shantha Biotechnics (Hyderabad) developed a cost-effective manufacturing process for hepatitis B vaccine (Shanvac-B), India's first indigenously developed recombinant DNA product, driving down the price from US$15 per dose for the imported product to US$0.50, and is now supplying about 30 percent of UNICEF's global requirement for hepatitis B vaccine.

Companies: Bharat Biotech, Shantha Biotech (acquired by Sanofi), Bigtech laboratories, Xcelris Labs, Tulip group, Avesthagen, Panacea Biotech, Biocon, Bayer cropscience AG, Dr Reddy's, Intas, Zydus Cadila etc.

Clinical Research- Clinical trials are sets of tests in medical research and drug development that generate safety and efficacy data and more specifically, information about adverse drug reactions and adverse effects of other treatments for any new drug to be launched in health sector. Clinical trials can vary in size, and can involve a single research entity in one country or many such entities in multiple countries.

Contract research organizations (CROs) provide comprehensive clinical monitoring, feasibility studies, data management, biostatistics and medical writing services for execution of phase I, II and III studies.

India is gaining importance as a clinical trial destination. According to a joint study by an industry body and Ernst and Young (E&Y) released in August 2009, the industry-sponsored Phase II, Phase III clinical trial sites in India have grown by 116 per cent during June 2008 and August 2009, with the country moving from rank 18 to 12 across the 60 most active countries. India participates in 7 per cent of the global Phase III trials and 3.2 per cent in the Phase II trials with industry-sponsored trials having grown by 39 per cent CAGR during 2004-08.

Companies: Clinexa, ACT, GVK, Veeda, Quintiles etc

Natural Products- R&D units in this area are integrating traditional knowledge with modern science to develop both animal and human health care products.

They Isolate, purify and characterize phytocompounds from different medicinal plants for use as reference substances in chromatography. Identify herbs with therapeutic value, perform pharmacological assays and clinical trials of natural product extracts, develop or upgrade formulations and develop nutraceuticals and health supplements. The R&D facility also works for advanced standardization, quality assurance and efficacy for achieving quality certification equivalent to global standards.

Companies: Natural remedies, Baidyanath, Laila, Olive Lifesciences, Dabur etc

New drug Discovery – Development of New Chemical Entities, NCE i.e compound which, previously, hasn't been described in scientific literature and is responsible for the physiological or pharmacological action that could translate into a drug after clinical trials.

New drug discovery companies are engaged in enhanced innovativeness in pre- clinical research, in the fields of oncology, inflammation and infectious diseases (Malaria, TB, MRSA & Gram negative infections). They have fully integrated Drug Discovery platform developing cutting-edge, novel ideas from concept to *animal* validation/ lead optimization in Pre-clinical development.

Companies involved are Ranbaxy (Daiichi sankyo), Orchid, Astra Zeneca, Wockhardt, Dr Reddy's, GVK, Syngene International Limited, etc.

Generics R&D – Most of the Indian pharmaceutical companies are into Generic drug manufacturing. Generic drugs are copies of brand-name drugs and are the same as those brand name drugs in dosage form, safety, strength, route of administration, quality, performance characteristics and intended use. However they can develop new salts, esters of existing ingredients or chemical derivatives of active ingredient.

Generic drugs can be produced without patent infringement for drugs where: 1) the patent has expired, 2) the generic company certifies the brand company's patents are either invalid, unenforceable or will not be infringed, 3) for drugs which have never held patents, or 4) in countries where the drug does not have current patent protection. Patent lifetime differs from country to country; typically an expired patent cannot be renewed.

Generic company takes the advantage of high volume, low priced commodity generics. Companies: Cipla, Sun pharma, Glenmark, Torrent, Ranbaxy etc

Formulation Development – The efficacy of Generic drug formulation must meet the quality standards of branded drug. During formulation, scientists compare their recipe with the innovator drug to ensure it has a very close profile without impurities. The U.S. Food and Drug Administration (FDA) require bioequivalence to be between 80% and 125% of the innovator product.

High quality, technology driven product development is carried out to produce a stable and clinically safe and effective formulation. A variety of dosage forms are being developed as Tablets (conventional, chewable dispersible, orally dissolving, extended release, enteric coated etc.), Capsules, Semi-solids (ointment, cream, gel, lotion) and Liquids (solution, suspension). New excipients apart from innovator product can be added for formulation development.

Companies: All Generic R&Ds

Process Development – The research focus is on developing new process and improves yields of tailor-made active pharmaceutical ingredients (APIs). The development of practically robust and cost effective processes for the synthesis of APIs has critical implications for subsequent manufacturing and commercialization of Generics by gaining process patents. R&D is to be supported by a Kilo Lab to scale up the flask technology to reasonable scale.

Companies: All Generic R&Ds

Novel drug delivery systems for developing novel effective systems for delivering the drugs in the body, new dosage forms for patient compliance and to overcome resistance/side effects, sustained release of drug in body or improvise the existing technologies to enhance drug efficiency and packaging development for improved storage and reduced contamination.

Companies: Suven, Jubilant lifesciences, Orchid, Torrent, Fresenius, etc

Custom synthesis - Create scalable, robust and cost-effective synthesis processes across multiple chemistry and therapeutic categories by in-house analytical capabilities and quality manufacturing assets. These R&D centres provide innovative route scouting, process R&D and rapid-response custom synthesis of regulatory starting materials, advanced intermediates and APIs for preclinical – Phase III clinical studies.

Companies: GVK, Chembiotek, Surya, Arch Pharma Labs etc.

Physiochemical Characterization of molecules - Drug Metabolism and Pharmacokinetic (DMPK) and bioanalytical ADME services such as drug solubility, stability, excretion, permeability, CYP inhibition, protein binding within human/animal system to advance discovery and preclinical drug development activities.

Companies: Advinus etc

Animal toxicology studies- These R&Ds offers GLP-compliance regulatory toxicology studies for Investigational New Drug (IND) application as well as non-GLP pharmacology and toxicology studies in order to provide preliminary assessment of a drug's safety and toxicity. A comprehensive range of studies in general and reproductive toxicology, carcinogenicity and safety pharmacology are available.

Companies: Aurigene, GVK, RCC laboratories etc

Future Business:

India has raised its technology capability through reverse engineering but lagged behind in developing skills to support discovery-oriented innovative research. Hence, collaborative research partnership with large and mid-sized pharma companies is a new business model selected by Indian R&D units.

Based on the assumption that relevant global R&D spending is perhaps close to 60 billion dollars with a split of 33:66 in the non-clinical to clinical spend level, and current

trends indicating that the fully-loaded cost of operations in India is 1/3rd and 1/5th of costs in the US and Western Europe for non-clinical and clinical operations respectively, the global R&D spend at Indian prices works out to approximately 15 billion dollars. A worthwhile target for India may be to begin to attract 10% of that spend – the equivalent of $1.5 billion.

This could be achieved by very strong fiscal incentive of import duty waiver on commercial pharmaceutical imports to promote large pharmaceutical companies to consider major growth in research spending in India.

A list of major pharmaceuticals companies having R&D centers recognized with DSIR and their annual R&D expenditures is enclosed.

Sl. No	Name of the firm	R&D Expenditure Reported (Rs. in lakhs) *
1	Ajanta Pharma Ltd.	2196
2	Alembic Ltd.	4898
3	Aurobindo Pharma Ltd.	1732
4	Arch Pharma Labs Ltd.	2576
5	Bharat Serums & Vaccines Ltd.	2838
6	Biocon India Ltd.	12450
7	Biological E. Ltd.	6853
8	Cadila Healthcare Ltd.	30170
9	Cadila Pharmaceutical Ltd.	2600
10	Cipla Ltd.	23240
11	Claris Life Sciences Ltd.	2077
12	Dishman Pharmaceutical & Chemical Ltd.	863
13	Divi`s Laboratory	2166
14	Dr. Reddy's Laboratories Ltd.	59180
15	Emcure Pharmaceuticals Ltd.	3969
16	FDC Ltd.	2080
17	Glaxo Smithkline Pharmaceutical Ltd.	581
18	Glenmark Pharmaceutical Ltd.	5051
19	Gennova Biopharmaceuticals Ltd.	772
20	Himalaya Drug Company	804

21	Indoco Remides Ltd.,	1014
22	Intas Pharmaceuticals Ltd.	10593
23	Jubilant Organosys Ltd.	6091
24	Lupin Ltd.	26690
25	Malladi Drug and Pharmaceuticals Ltd.	660
26	Matrix Laboratories Ltd.	29369
27	Micro Labs Ltd.	710
28	Natco Fine Pharmaceuticals Pvt. Ltd.	506
29	Nicholas Piramal Pvt. India Ltd.	9115
30	Novartis Healthcare Pvt. Ltd.	1113
31	Pfizer Ltd.	2429
32	Ranbaxy Laboratories Ltd.	49015
33	Regent Drug Ltd	2067
34	Serum Institute of India. Ltd.	6530
35	Shantha Biotechnics Pvt. Ltd.	2630
36	Shasun Chemical and Drugs Ltd.	2850
37	Shasun Pharmaceuticals Ltd.	1426
38	Strides Arcolab Ltd.	3050
39	Sun Pharmaceuticals Industries Ltd.	38387
40	Surya Pharmaceutical Ltd.	2490
41	Themis Laboratories Pvt. Ltd.	554
42	Torrent Pharmaceuticals Ltd.	3191
43	Unichem Laboratories Ltd.	2445
44	USV Ltd.	5168
45	Wockhardt Ltd.	2359

Annexure-V

Note received from Mr. D.G Shah, President, IPA on 'Safe Harbour – Pharmaceutical Sector'

1. Introduction:

The pharmaceutical industry is unlike many others. Its wide variety of products, long gestation period of high risk research and development, and the influence of Intellectual Property Right (IPR) Regime and the National Drug Regulatory Authority on its working make it unique. Its two main areas amenable to safe harbor are import-export trade and out licensing of research outcomes.

2. Import-Export Trade:

1. No country in the world, however advanced, is fully self-reliant for its medicinal needs. This is evident from the global trade data as well as India's trade in pharmaceuticals as noted below:

Exports and Imports

Year	Exports Rs.cr	Growth %	Imports Rs.cr	Growth %
Mar 1995	1,701.13	-	937.21	-
Mar 1996	2,498.52	47	1,357.95	45
Mar 1997	2,991.48	20	1,089.18	-20
Mar 1998	3,396.12	14	1,447.12	33
Mar 1999	3,923.62	16	1,615.20	12
Mar 2000	4,801.46	22	1,616.22	0
Mar 2001	5,654.37	18	1,711.81	6
Mar 2002	7,385.95	31	2,026.58	18
Mar 2003	9,809.31	33	2,865.20	41
Mar 2004	12,466.12	27	2,958.04	3
Mar 2005	14,385.16	15	3,169.35	7
Mar 2006	16,724.33	16	4,550.87	44
Mar 2007	22,736.95	36	5,851.64	29

Mar 2008	27,155.53	19	6,712.93	15
Mar 2009	33,412.45	23	8,674.80	29
Mar 2010	36,683.34	10	9,960.38	15

Source: CMIE

As may be seen from the above table, the imports have phenomenally increased since 2006 and have more than tripled during 2005-10 from Rs 3,169 cr in 2005 to Rs 9,960 cr in 2010. A substantial part of this consists of high priced finished products (formulations) imported by the foreign companies.

2. The exports consist of Active Pharmaceutical Ingredients (APIs) commonly referred to as bulk drugs and finished dosage forms (Tab, Cap, etc.) commonly referred to as formulations.

3. The APIs are exported directly to manufacturers as well as through traders. If the trader is buying and selling APIs, he pockets the price difference. On the other hand, if the trader is procuring orders for the manufacturer, he gets commission. Most of these transactions are through non-related entities.

4. The exports of formulations are of three types:

    a. Contract Manufacturing for the foreign companies;
    b. Direct supply to distributors in the importing countries; and
    c. Sales and marketing by own entity in the importing countries.

The domestic companies depending on their business model follow all or any of the above noted three modes. The foreign pharmaceutical companies sourcing products from India mainly follow mode (a). They transfer products procured from contract manufacturers to their international supply point, which marks-up the price and sells to their subsidiaries/affiliates in various parts of the world.

5. The imports of APIs are direct as well as by traders who pocket price difference or get commission. The domestic companies mainly use imports of APIs from China.

6. The imports of formulations are almost exclusively by the foreign companies from their affiliates. As the medicines are exempt from import duties, the prices tend to be on the higher side to maximize profit at the supply point.

3. Research and Development:

1. The private investment on R&D in Pharmaceutical Sector by domestic companies has increased 40-fold over the last 15 years from Rs 80.61cr in 1994-95 to Rs 3,342.32cr in 2009-10 representing 4.5% of domestic sales in 2009-10. As against this, the foreign companies which have know-how, history of investing in R&D and had promised, during the TRIPS negotiations, to invest in India increased their annual R&D spend from Rs 64.13cr in 1994-95 to Rs 934.40cr only in 2009-10.

Research and Development Expenditure

Year	**Growth in R&D Expenditure Rs Cr**		**R&D Expenditure As % of Sales**	
	Domestic Companies	**Foreign Companies**	**Domestic Companies**	**Foreign Companies**
Mar 1995	80.61	64.13	1.34	0.77
Mar 1996	142.50	83.37	1.71	0.91
Mar 1997	148.12	89.41	1.55	0.95
Mar 1998	154.15	90.65	1.43	0.88
Mar 1999	218.66	79.78	1.56	0.70
Mar 2000	256.80	90.17	1.56	0.66
Mar 2001	435.07	109.81	2.30	0.72
Mar 2002	597.91	110.04	2.64	0.65

Mar 2003	686.74	232.73	2.93	0.71
Mar 2004	1084.26	346.69	3.81	1.10
Mar 2005	1527.24	510.50	4.98	1.63
Mar 2006	1850.97	816.02	5.35	2.39
Mar 2007	2371.79	695.62	5.01	2.67
Mar 2008	2772.63	700.18	4.78	2.86
Mar 2009	3316.14	846.05	4.89	3.84
Mar 2010	3342.32	934.40	4.50	4.01

Source: CMIE

2. It is pertinent to note that R&D intensity of pharmaceutical industry is unique. It takes about four years and $ 2 mn to bring a generic product to market. The current estimate by the Indian companies to bring a new molecule to market is 10 years and $ 200mn.

3. The R&D activities of the domestic companies follow two models:

   a. Contract Research for Foreign Companies; and
   b. In-house R&D for own business.

   The contract research is more like "body shopping" and somewhat similar to early stage IT work.

4. The in-house R&D is used for competitive edge in the global markets. However, as the pharmaceutical R&D is prolonged and risky, the companies out license their work at various stages of development. The risk at the early stage of development is higher and hence realization is lower. On the other hand, as the product/process moves forward successfully on the development path, the risk for the licensee is lower and hence realization is better.

Annexure-VI

Note received from the Director of Income-tax, (Transfer Pricing) Ahmedabad on Safe Harbour on Pharmaceutical Sector

Safe Harbour Rules for Pharmaceutical Industry

The Market:

The Indian Pharmaceutical Industry represents one of the most advanced pharma industries in the Asia Pacific region. The Indian Pharma industry is into manufacturing of both bulk drugs, drug intermediates, pharmaceutical formulations and vaccines both for local as well as export consumption. Owning to a large population with expectations of cheaper drugs, the Indian Pharma industry is dominantly engaged in production of generic drugs. Indian companies have been catering to both, the local market with high consumption of generic products as well as the highly lucrative overseas markets where the Indian companies have been vying to take advantage of expiring patents. With implementation of Indian regulations related to manufacturing and compliance of international manufacturing standards by the Indian companies, the reliability of the Indian drugs as well as their international reach has grown many fold.

With development of the R&D capability of the Indian companies as well as the manufacturing set up, the Indian companies have been aggressive players in the International market in the area of bulk drugs as well as formulations. In the area of formulations, the competition is high in the normal generics while the companies enjoy handsome margin in the drugs which have come off patent recently or chapter IV drugs.

The Cost Advantage:

India has emerged as a highly cost effective base for outsourcing pharmaceutical production. The Indian advantage arises out of a number of factors. The country offers highly competent scientific manpower at extremely competitive rates. With development of organized hospital setup across the country and high end research facilities developed by the Pharma companies, it is easy for these companies to develop generic equivalents before patents expiry to reap the

benefits of higher cost of such drugs. As per Cygnus Outsourcing Opportunities in India Pharmaceutical Industry, such benefits are

- Easy availability of skilled technical human resources with experience in low cost manufacturing,
- Human resource costs in India are 85% to 90% lower than in US
- Setting up FDA approved plant in India is 30% to 50% cheaper as compared to US
- Bulk drug production is 40% to 50% of the costs in US and
- Intermediates are 20% - 30% lower than in US.

This cost advantage has led to handsome profits to the Indian companies both at domestic level as well as in international market. Since development of a drug, even at generic level, is a long and expensive process, the margins for the companies are sufficiently high – both at domestic as well as at international level.

Since the margins for drugs at international level is quite high, the Indian Manufacturers have adopted the model of central research and global marketing. The drugs are developed in India, necessary documentation including clinical trial documentation is also conducted within the country and the companies have their marketing offices outside to ensure marketing of their products.

Clinical Research:

In light of developed research facilities, huge hospitals with a variety of patents and technically skilled doctors, the clinical research and consequent development of new drugs is fast and can be achieved at a fraction of costs which would have been incurred outside the country. The Indian Phrama groups have developed sufficient expertise in all the areas of such research – drug discovery, product development and formulations, pre-clinical and clinical trial management (phase I to IV). Low cost base, govt and regulatory support and large patient base gives India a unique advantage to develop as a centre for clinical research and drug trials for new drugs.

The Indian Model for manufacturing

The Indian Pharmaceutical industry, while operating in the export market, functions either as a manufacturer or as a contract manufacturer on behalf of the foreign patent holder. Indian manufacturers have demonstrated skills for manufacturing generic version of block buster drugs at very low costs. This, coupled with large number of FDA approved manufacturing facilities, low R&D costs, low cost of development of drugs which are going off patent in the near future, the margins of Indian manufacturers is expected to be higher than normal, in respect of both these segments, either as a manufacturer or as a contract manufacturer.

Application of safe harbor margins in respect of Indian Manufacturers:

As discussed above, the margins in the Indian Pharmaceutical Industry has shown wide fluctuations – both in respect of domestic as well as International markets. While the entity level margins in case of such manufacturers has been seen to vary between 5 to 40%, some pharmaceutical manufacturers have shown margins as high as 60 to 65% from some of their units. In respect of drugs which are just going off patent or which have been sold under chapter IV filing, the margins exceed 100% also, although subsequent litigation cost in such cases may be quite high.

The Indian companies have been quite aggressive in marketing their products – both in respect of developing ANDA for drugs going off patent as well as marketing products in US markets through para III and para IV filings. The margins as well as associated risks in para IV are totally different from other generic sales and cannot be quantified or limited by safe harbor rules. Further, the Indian Pharma manufacturers are now focusing on niche segments like Dermatology, Oncology, New Drug Delivery Systems etc where the margins are exceptionally high. Hence, it is difficult to arrive at an expected margin of profit if there is a significant change in the nature of drug being marketed by a manufacturer.

In light of the huge variation in profits depending on the markets, patent related status and the nature of drugs being marketed, it is very difficult to arrive at a safe harbor margin in respect of any segment of pharmaceutical industry, be it generic drugs, bulk drugs, formulations or vaccines. Ascribing a safe margin in respect of Pharmaceutical Industry is not possible in such a scenario and is not advisable.

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Sixth Report of the Committee to Review Taxation of Development Centres and the IT Sector

(Safe Harbour for Auto Ancillaries Sector – [Original Equipment Manufacturers])

17th April, 2013

FOREWORD

The Prime Minister had constituted a Committee to Review Taxation of Development Centres and the IT Sector and to recommend Safe Harbour provisions for taxpayers doing business in certain sectors. The Committee has already submitted five reports to the Government and is happy to furnish its last report today. This report is the fifth on Safe Harbour provisions. The first report, submitted on 14th September, 2012, had addressed the taxation issues confronting the IT Sector and the Development Centres. The second report (first on Safe Harbour provisions), submitted on 13th October, 2012, had laid down the recommendations for Safe Harbour provisions for the IT-Software and ITES sectors. The third report (second on Safe Harbour provisions), submitted on 18th December, 2012, had recommended Safe Harbour provisions for two areas of the financial sector, i.e., Outbound Loans and Corporate Guarantees. The fourth and fifth reports (third and fourth on Safe Harbour provisions) were submitted recently and contained the Committee's recommendations for Safe Harbour provisions in respect of Contract R&D in the IT Services Sector and Pharmaceuticals Sector.

This report, the sixth, contains the Committee's recommendations for Safe Harbour provisions for the Auto Ancillaries Sector [Original Equipment Manufacturers].

While furnishing this report, I must duly acknowledge the valuable contributions made by its members, namely, Ms. Anita Kapur, Member (A&J), CBDT, Ms. Rashmi Saxena Sahni, DIT (Transfer Pricing-I), Delhi and Mr. Dinesh Kanabar, Tax Expert, in examining the issues and finalizing the Committee's approach. All of them have displayed tremendous commitment to the job at hand and a rare degree of intellectual ability to understand the complex issues. Their invaluable inputs have enabled the Committee to finalise its recommendations.

I would also like to place on record the Committee's appreciation of the onerous work put in by the three senior officers of the Department, namely Shri Subhakant Sahu, Shri D. Prabhakar Reddy and Shri Sobhan Kar, Addl. Commissioners of Income-tax, to assist the Committee in finalizing its six reports.

Since this is the last report of the Committee, I would take this opportunity to sincerely thank the Prime Minister and the Finance Minister for reposing faith in this Committee to suggest implementable recommendations in a very complex arena of taxation. The Committee also places on record its gratefulness to the Revenue Secretary and the Department of Revenue for the support provided to it. The Committee is equally grateful to the

Chairman, Central Board of Taxes and her team of officers, led by DGIT (International Taxation), for offering unstinting support to the Committee by way of making available invaluable data pertaining to transfer pricing audits. I am personally grateful to the Chairman, CBDT for allowing me to utilise the services of some of her finest officers as Members of the Committee and for assisting the Committee.

Last, but not the least, the Committee wishes to express its gratitude to all the stakeholders [Departmental and other Government Officers, Chambers of Commerce, Industry Associations, Academicians, Companies, Professional Chartered Accountants, etc.], who provided the Committee with invaluable inputs and insights, which immensely enriched its reports.

N. Rangachary,
Chairman
17 April, 2013

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Sixth Report of the Committee to
Review Taxation of Development Centres and the IT Sector

(Safe Harbour for Auto Ancilliaries Sector [Original Equipment Manufacturers])

Submitted by

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Chairman

PART - 1: INTRODUCTION

1.1 Prime Minister's Office issued a press release on July 30, 2012 **(Annexure-I)**, stating that the Hon'ble Prime Minister had constituted a Committee to Review Taxation of Development Centres and the IT Sector under the Chairmanship of Shri N. Rangachary, former Chairman CBDT & IRDA. The Committee submitted its first report to the Government on 14th September, 2012 covering issues listed in the terms of reference of the Committee, except the following:

"Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector."

1.2 The rationale for entrusting the Committee with the task of finalising Safe Harbour rules was explained in the Press Release (ibid) as follows:

"As far as Safe Harbour provisions are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer"

1.3 Vide Office Memorandum dated 13th September, 2012 **(Annexure-II)**, the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors / activities:

(a) IT Sector

(b) ITES Sector

(c) Contract R&D in the IT and Pharmaceutical Sector

(d) Financial Transactions – Outbound loans

(e) Financial Transactions – Corporate Guarantee

(f) Auto Ancillaries – Original Equipment Manufacturers

1.4 The Committee submitted its second report, the first on Safe Harbours, on 13th October 2012 to the Government. That report contained its recommendations for Safe Harbour rules for IT and ITES sectors.

1.5 The Committee's third report, which made recommendations for Safe Harbour rules for financial transactions of outbound loans and corporate guarantees, was submitted on 18th December 2012.

1.6 The Committee's fourth and fifth reports, which contained Safe Harbour recommendations on Contract R&D in the IT Sector and Pharmaceutical Sector, respectively, have been submitted on 5th and 9th April, 2013.

1.7 This report, the Committee's sixth and final, contains Safe Harbour recommendations for Auto Ancillaries – Original Equipment Manufacturers. With the submission of this report, the mandate of the Committee stands completed.

***

PART - 2: DELIBERATIONS IN THE COMMITTEE

2.1 Part 2 of the first report of the Committee on Safe Harbours (Second Report of the Committee) for the IT (Software) & ITES sectors included a detailed analysis of the statutory provisions regarding Safe Harbours [Section 92CB of the Income-tax Act], the need for having Safe Harbours and the opposition to the same, types of Safe Harbours, cross country transfer pricing simplification measures, and existing transfer pricing simplification measures in India.

2.2 Since those concerns, analyses and explanations, in the view of the Committee, are equally relevant for this report, reference is invited to the said portion of the first report on Safe Harbours. **However, no detailed discussion on these issues is being incorporated here to avoid repetition.**

2.3 Suggestions and data to frame Safe Harbour provisions for Auto Ancillaries – Original Equipment Manufacturers were invited from the following stakeholders:

- Central Board of Direct Taxes (CBDT)
- Department of Heavy Industry
- SIAM (Society of Indian Automobile Manufacturers)
- ACMA (Automotive Component Manufacturers Association of India)
- CII (Confederation of Indian Industry)
- FICCI (Federation of Indian Chambers of Commerce and Industry)
- ASSOCHAM (Associated Chambers of Commerce and Industry of India)
- PHDCCI (PHD Chamber of Commerce & Industry)
- ICAI (Institute of Chartered Accountants of India)
- PWC (Price Waterhouse Coopers)
- E&Y (Ernst & Young)
- Deloitte Haskins & Sells
- KPMG
- BMR Advisors

- Vaish & Associates, Delhi
- SR Dinodia & Company, New Delhi
- BMW
- FIAT

2.4 Data and comments of the CBDT were received for the consideration of the Committee. The comments of DIT (Transfer Pricing), Ahmedabad, dated 13th February, 2013, forwarded by the office of the DGIT (International Taxation) vide letter dated 22nd February, 2013 to the Committee **(Annexure - III)**, have been considered.

2.4.1 The Society of Indian Automobile Manufacturers (SIAM) has provided a general note on Transfer Pricing issues, dated 6th March,2013, without focussing exclusively on Safe Harbour in the Auto Ancillaries Sector (**Annexure-IV**). The Department of Heavy Industry, Ministry of Heavy Industry & Public Enterprises, has responded vide Office Memorandum in reference No. 4(2)/2013-AE-I, dated 20th March, 2013 **(Annexure-V)**. They have emphasised the need for clarity and have supported the contentions of SIAM. Their general suggestions include constitution of a single authority to decide the Arm's Length Price (hereinafter referred as ALP in this report) for both direct and indirect taxes, no cherry picking of comparables, detailed Functions, Assets and Risks (FAR) analysis and use of multiple year data. Some of these have already been acknowledged in the First Report and others are not covered by the mandate of this Committee.

2.4.2 S.R Dinodia and Company, New Delhi, has suggested segregation of auto ancillaries / components sector into core and non-core and also suggested a need for Safe Harbour for royalty transactions **(Annexure-VI)**.

2.4.3 The CII (Confederation of Indian Industry) has given a note giving suggestions for Safe Harbour in general and also with reference to this sector. The full note may be seen at **Annexure-VII**. It has emphasised the dependence of the Automotive Industry on know-how and other intangibles

for design and innovative automotive systems. According to CII, the transactions of technical know-how or technical services are significantly increasing and there is an opportunity for India to leverage its large knowledge base.

2.4.4 Comments have also been received from OEMs like FIAT and BMW. However, they do not have contextual relevance with the mandate of the Committee.

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PART - 3: SETTING THE CONTEXT

3.1 In terms of Auto industry, India is the sixth largest market after China, USA, Germany, Japan and Brazil. The auto sector reported a robust growth rate of 26% in the years 2010-11 and 2011-12 but the growth has slowed down significantly in 2012-13.

3.2 Following is the Vision 2016, as included in the Automotive Mission Plan 2006-2016 of Ministry of Heavy Industry & Public Enterprises, Government of India (hereinafter referred to as **"Mission Plan"**):

Quote:

> *To emerge as the destination of choice in the world for design and manufacture of automobiles and auto components with output reaching a level of US$ 145 billion accounting for more than 10% of the GDP and providing additional employment to 25 million people by 2016.*

Unquote

3.3 The Report of the Working Group on Automotive Sector for the 12th Five Year Plan (2012-2017) [1] (hereinafter referred to as **"Report of the Working Group"**) has identified this sector as a key growth driver due to its deep forward and backward linkages, which have a strong multiplier effect. According to the report, the Indian Automobile Industry is growing at a good pace after economic liberalisation in 1991. Today, the industry, according to the report, is characterised by -

- *Growing number of manufacturing facilities.*

[1] Report of the Working Group on Automotive Sector for the 12th Five Year Plan (2012-2017) - Department of Heavy Industry, Ministry of Heavy Industry and Public Enterprises, Page 13, Para 1.2

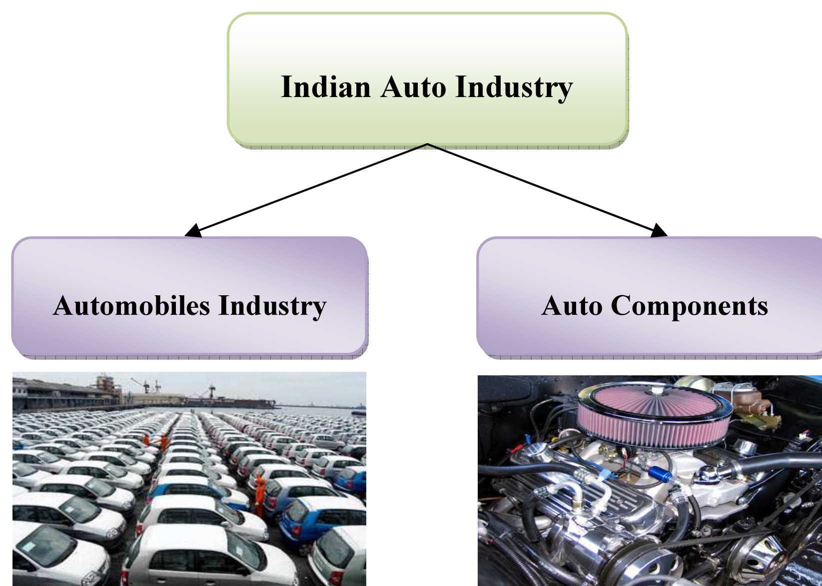
- *Production of a wide variety of vehicles: passenger cars, light, medium and heavy commercial vehicles, multi-utility vehicles such as jeeps, two wheelers such as scooters, motor-cycles and mopeds, three wheelers, tractors and other agricultural equipments, etc.*

- *It has grown at a Compound Annual Growth rate (CAGR) of over 15% during the last 5 to 7 years, due to which it is identified as the next sunrise sector of the Indian economy.*

- *The volumes, exports and turnover have increased by 3.8, 19.6 and 6 times, respectively, in the last ten years.*

- *Increasing contribution of this sector to the National GDP, rising from 2.77% in 1992-93 to close to 6% now.*

3.4 The Report of the Working Group [2] depicts the structure of the Auto Industry in India as follows:



3.4.1 There has been a steady increase in the turnover in this industry. The Report of the Working Group states as under: [3]

[2] Ibid, Para 1.4

Quote:

The turnover of the auto component industry, in 2010-11 was USD 40 Billion (1,79,320 cr. approx.)3. The export of vehicles and auto components during 2010-11 stood at USD 6 Billion and USD 5 Billion respectively. In 2010-11, the contribution of the automotive industry to the manufacturing GDP and the excise duty was at 22% and 21% respectively

Unquote

3.4.2 The Report of the Working Group [4] further substantiates, in terms of value, the domestic sales turnover and exports of the Auto Ancillaries/components sector as under:

Auto components sector's performance – Estimation for 2012-17

(USD billion)

	2012-13	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**CAGR 2012-17**
Domestic Market Size	52.6	58.3	64.5	71.4	79.1	10.7%
Turnover	48.7	53.9	59.8	66.3	73.6	11.0%
Export	7.3	8.7	10.3	12.3	14.6	18.8%

3.5 Briefly stated, at present, the automobile sector in India

- includes almost all the major global Original Equipment Manufacturers (OEMs) as well as home grown companies;
- has surpassed France, UK and Italy in 2010-11 to make India the 6th largest vehicle manufacturer globally;

[3] ibid, Page 13, Para 1.5

[4] ibid, Page 51

- is the largest manufacturer of tractors, second largest manufacturer of two wheelers, fifth largest manufacturer of commercial vehicles and the fourth largest passenger car marker in Asia;
- exported 2.35 million vehicles to more than 40 countries during 2000 to 2011, which included 0.45 million passenger cars and 1.54 million two wheelers; and
- provides direct and indirect employment to 13.1 million people.

3.5.1 Further, today, the Indian automobile sector has :

- 19 manufacturers of passenger cars & multi utility vehicles;
- 14 manufacturers of commercial vehicles;
- 16 manufacturers of 2 and 3 wheelers;
- 12 manufacturers of tractors; and
- 5 manufacturers of engines.

3.6 The auto ancillary or auto component sector is a highly fragmented sector in terms of types of products, vendors, market, transactions, turnover and profit margins. It has component manufacturers both for OEMs (Original Equipment Manufacturers or vehicle manufacturers) and replacement market, also called the aftermarket. This sector includes both exporters and importers of components. It has organised and unorganised sector players manufacturing both core and non-core components. There are about 500 component manufacturers in the organised sector and even a larger number in the unorganised sector.

3.6.1 The 500 organised sector players of the Indian auto component or auto ancillary sector reached a turnover of over USD 14 billion in 2005-06. Demand from OEMs account for 67% of sales while replacement market accounts for 19% at about USD 2.0 billion. This is exclusive of tyres, batteries and imported components. [5]

[5] Automotive Mission Plan 2006-2016, Para 2.3.7

3.6.2 Characteristics of the auto ancillary/component sector as delineated in the Mission Plan [6] are as follows:

> *"Auto component industry growth is directly linked to the growth of automobile industry since more than 65% sales is to the OEMS. However, in recent years, component exports are becoming an important growth driver and it is expected to assume greater importance in future."*

3.6.3 An EXIM Bank Study [7] also supports the above conclusion by stating that, "The trends in auto-components industry are dependent on the trends in the automobile industry, as the original equipment manufacturers are the principal customers for the auto components industry. Though there is a replacement market as well, the trends in automobiles industry still influence the growth of auto- components industry."

3.6.4 The EXIM Bank Study [8] also states that globally the industry,-

- is in the process of undergoing a structural change;
- is being influenced by strategies of OEMs, globalization, business and technology trends;
- is facing rise in input costs and, therefore, companies are moving to low cost destinations, so as to be cost efficient;
- is witnessing mergers and acquisitions, as well as, consolidation as most of the companies are hiving-off their peripheral businesses and concentrating on their core business;
- is witnessing more and more companies becoming system integrators rather than being mere suppliers; and

[6] Ibid, Para 2.4.5
[7] Indian Automotive Industry: At the cross roads, Occasional paper No.129 of Exim Bank , Dec2008, page,15
[8] ibid

- due to all the above trends, countries like China, India and Thailand stand to gain significantly.

3.6.5 India becoming a major player in the automobile industry (both OEMs and components sectors) is supported by the following overview provided in the Mission Plan: [9]

- There are around 500 firms in the organised sector producing practically all types of components and more than 10,000 firms in the small unorganised sector, in a tierised format.

- The industry, over the years, has achieved high degree of indigenisation both in the vehicle (OEM) industry and in the components industry for the 'Made in India' vehicles like the Tata Indica, Mahindra Scorpio, Bajaj Pulsar, TVS Star and TVS Victor.

- The component or ancillary industry has developed capability to manufacture the entire range of auto-components, i.e., Engine parts, Drive parts, Transmission parts, Suspension & Braking parts, Electricals, Body and Chassis parts, Equipment, etc.

- The components-wise share of production is as follows:

  - ✓ Engine parts - 31%;
  - ✓ Drive and Transmission parts - 19%;
  - ✓ Suspension & Braking parts -12%;
  - ✓ Electrical partss - 9%;
  - ✓ Body and Chassis parts -12%;
  - ✓ Equipment - 10%; and
  - ✓ Others (the balance of about 7%).

3.6.6 The Mission Plan[10] further indicates that the turnover of the components industry has increased from USD 3.1 billion in 1997-98 to USD 9.8

[9] Automotive Mission Plan 2006-2016, Page 17-18
[10] Ibid

billion in 2003-04. The growth can be attributed to low labour costs, availability of skilled labour and high quality consciousness among Indian vendors. In respect of exports of components from India, the Mission Plan[11] observes as below:

Quote:

During 2003-04, the exports of auto-component crossed the magic figure of USD 1 billion after having recorded a healthy growth of 25%. During the year 2004-05, the exports grew by 40% thereby taking the direct exports of components to a level of USD 1.4 billion. In the year 2005-06 exports grew by 28% and reached the level of USD 1.8 billion. It is pertinent to mention here that this figure is still very low against the volume of world trade of 185 billion USD in auto components.

Unquote

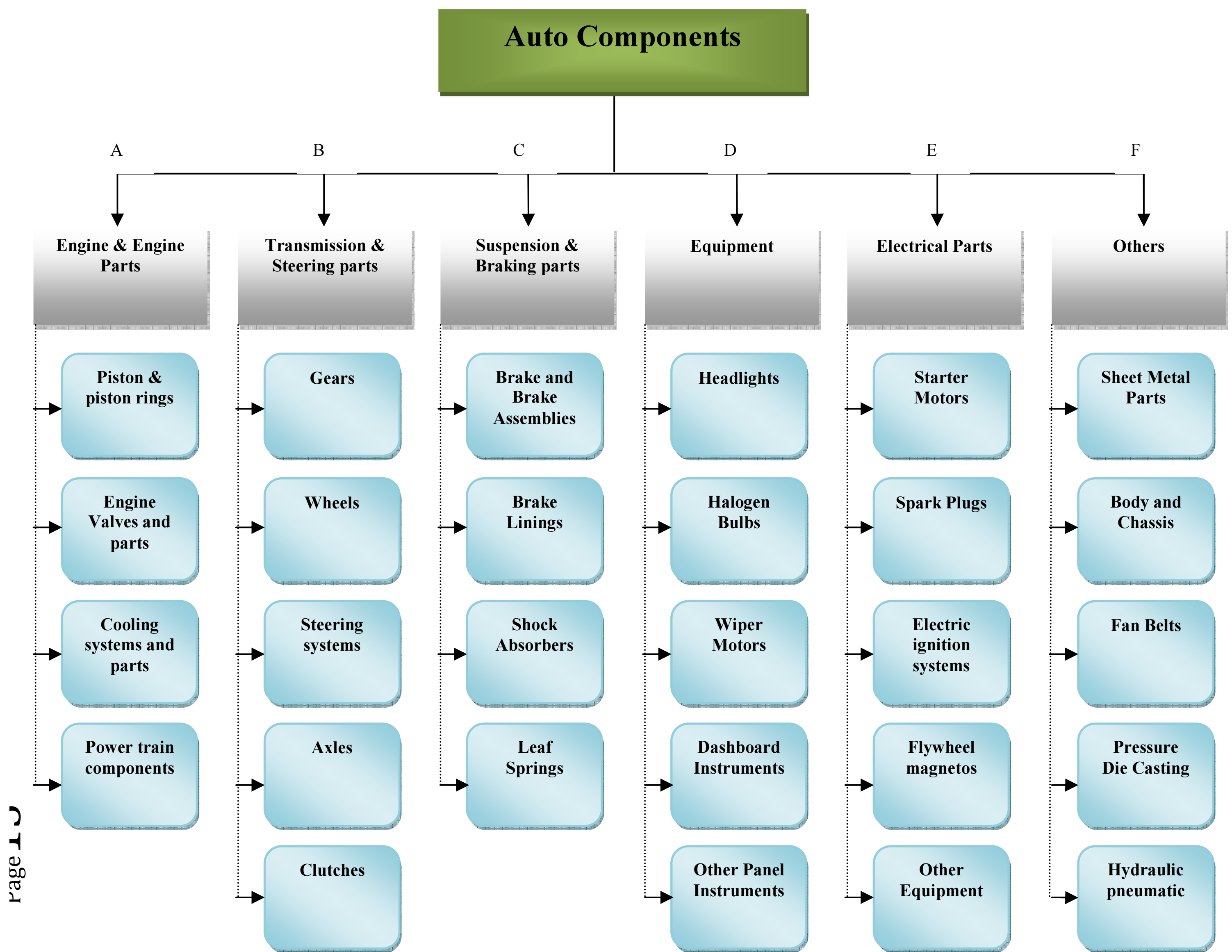
3.6.6.1 An additional factor for growth in the sector, as pointed out by the Director of Income-tax (Transfer Pricing), Ahmedabad (**Annexure – III**), is "less stringent environmental regulations (environmental regulations have rendered the production of parts like castings cost-prohibitive in developed countries). For instance, the metal casting process generates dust and it is estimated that foundries in Europe and USA on account of stringent environmental compliance spend roughly 5-6% of their sales on pollution control. Such costs are almost negligible in countries like India and other Asiatic nations."

3.7 As can be seen from the overview of the auto ancillary or the auto component sector, there are a variety of products in this sector and, the component industry now has the capability to manufacture the entire range of auto-components.

[11] Ibid, page 19

3.7.1 As mentioned earlier, the auto components or ancillaries sector can be further sub-divided into core and non-core segments. As one of the stakeholders, M/s S.R. Dinodia and Co. has stated in its note to the Committee (**Annexure – VI**), core components are those without which an automobile cannot run, such as, components of engine and engine parts, transmission & steering parts and suspension & braking Parts. The DIT (Transfer Pricing), Ahmedabad, in his note sent to the Committee (**Annexure-III**), has also identified some important components as core components.

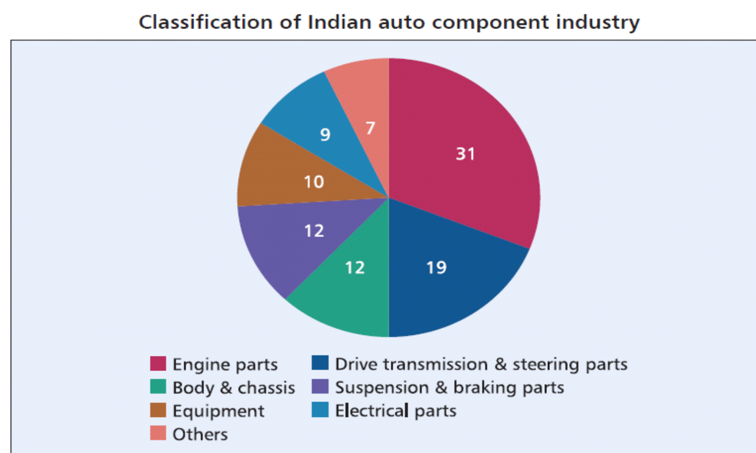
3.7.2 The structure of the Auto Ancillary or Component Industry [12] can be depicted graphically as below:



[12] Indian Auto Industry: Minor speed bump, but smooth ride ahead, Dinodia Capital Advisors, December 2012, page 13

3.7.3 The above discussion emphasises the fragmented nature of the auto components sector and showcases the product diversity. In the view of the Committee, therefore, there must be segregation of components into core and non-core as they are at different ends of the value chain. Thus, the above categorisation can be considered to segregate the auto components into core and non-core. The items listed above in columns A, B, and C would be considered as core components and the other items (listed in columns D, E, and F) would be treated as non-core components.

3.7.4 The relevant contribution of core and non-core components in the auto component industry is as follows:

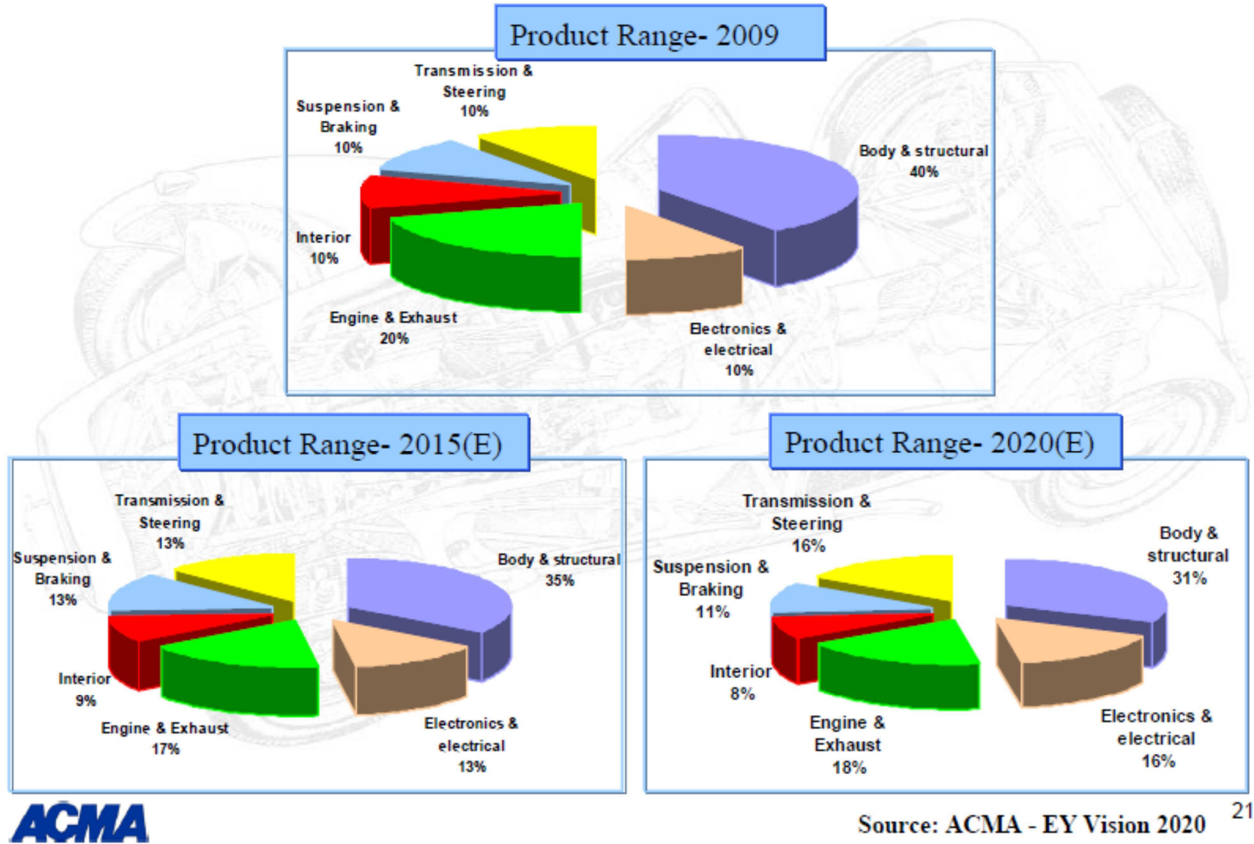


Source: Annual Report FY11, ACMA

3.7.5 As per the Report of the Automotive Component Manufacturers Association of India (ACMA), the core components segment would increase its share in the overall auto components industry by 2020, as shown below: [13]

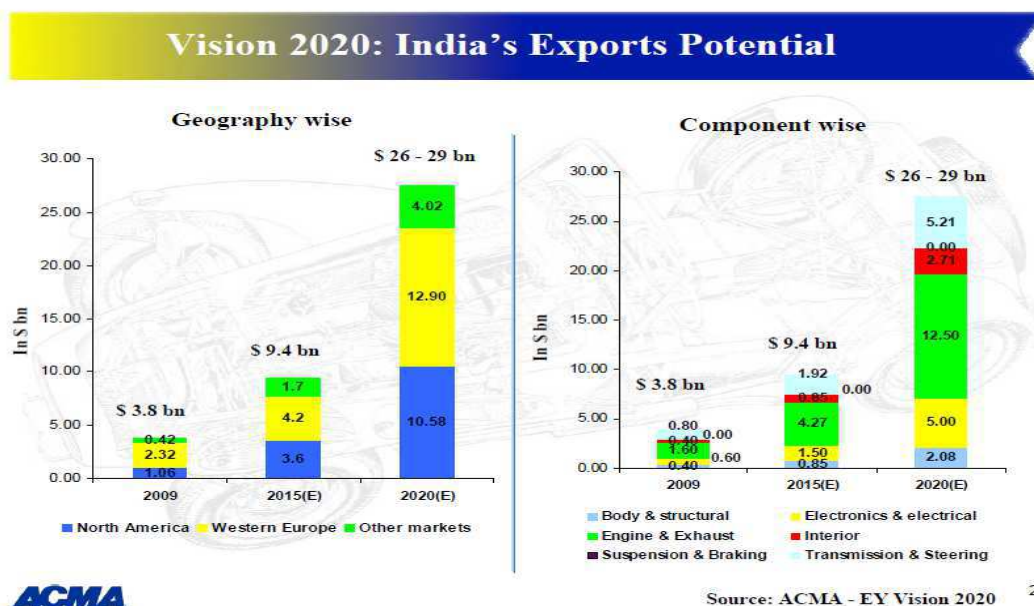
[13] ACMA – Status of Auto Industry - http://www.acmainfo.com/docmgr/status_of_auto_industry/status_indian_auto_industry.pdf

Page 1



3.7.6. Further, the OEMs of developed countries, mainly from North America and Europe, are increasingly sourcing their auto components from India. Some of the important sourcing OEMs are depicted as below:

3.7.7 There is also a growing demand in the export sector for the core components. As per the ACMA's Report on Status of Indian Automotive Industry [14], the exports of engine & exhaust systems may reach USD 12.50 bn by 2020 from USD 1.60 bn in 2009. Similarly, during the same period, export of transmission & steering components may reach USD 5.21 billion from USD 0.80 billion.



3.7.8 The Committee also noted the following distinction made by the DIT (Transfer Pricing), Ahmedabad (**Annexure-III**).

Quote:

REPLACEMENT MARKET

2.2.2 The huge unorganised sector typically caters to the demands from replacement market. The unorganised sector in turn is a low-cost one with the fiscal liabilities (in terms of excise duties) being not accounted for by this sector. As a result, this sector is able to supply the replacement market with significantly lower-priced parts vis-a-vis those produced by the organised sector. The after-market is highly competitive for components with a high price elasticity of demand

[14] ibid

and a tolerance of lower quality standards. A major channel of marketing and distribution for this sector is the typical roadside mechanic. The automotive component supplier also caters to the demands from the replacement market, apart from the original equipment one. Additionally, for automotive component suppliers, the prices in the replacement market are relatively higher than the prices in the original equipment market. This higher prices in the replacement market is because of the higher margins charged by the component suppliers, the impact of a longer supply chain and the tax structure. Typically, the replacement market provides higher margins but lower volumes vis-a-vis the OEM market.

Unquote

3.7.9 The Committee acknowledges that "core components" are those that require complex technology and functions in the process of manufacture and these components would form the heart of the automobile and determine its performance, including its mileage. For example, a car cannot run without an engine, clutch, and gear. However, it can run without mirror and door latches, which are non-core components. Further, these components decide the power, performance and comfort of the drive. It is also observed by the Committee, based on the analysis of margins by a stakeholder of independent companies (**Annexures-VIII & IX**), that the profit margins in both categories of products are also different.

3.8 Further, there is not only multiplicity of products but also variety of international transactions in this sector. This is apparent from the nature of international transactions typically reported in Form 3CEB [15], as illustrated below.

[15] Form 3CEB is the statutorily prescribed form for reporting International Transactions under the Income-tax Act.

3.8.1 General Component manufacturer/ distributor such as **ABC Ltd** [16] **has reported following activities for AY 2009-10**:

S. No.	Description of Transactions	Amount (in rupees)
1.	Purchase of raw material, components, Sub-assembly and spare parts	8,51,91,943
2.	**Sale of Raw Materials, consumables or any other supplies**	5,79,113
3.	Purchase of Tangible Movable property	32,53,97,370
4.	**Payment of royalty**	6,69,57,682
5.	Provision of Services: Payment of Training Charges:40,87,807 Payment of Design, Drawing & Testing Charges : 5,44,27,123 Payment of Absence Fees:3,71,95,935 Homologation Charges Received:9,31,574	9,66,42,439
6.	Reimbursement of Travelling Expenses	80,45,679

Or

3.8.2 M/s XYZ Ltd [17], a Captive **Component manufacturer/ distributor has reported following activities for AY 2009-10.**

S.N.	Nature of transactions	Value of transaction	Method Used
1.	Import of raw materials by the assessee from the AE	425,021,530	CUP/TNMM
2.	**Export/sale of components by the assessee to the AE**	178,649	CUP/TNMM
3.	Import of capital goods by the	13,494,192	CUP/RPM

[16] Name redacted
[17] Name redacted

	assessee from the AE		
4.	**Payment of royalty** for use of technical know-how and design and drawing fee as per the agreement	220,248,509	
		7,875,944	CUP/TNMM
5.	Technical services received by the assessee on deputation of technicians by the AE	2,071,357	TNMM
6.	Payment of interest of LCs	3,763,221	TNMM
7.	Payment of dividend	20,800,000	-

3.9 The analysis by the Committee indicates that the auto ancillary sector has its own peculiar characteristics due to multiplicity of products, as well as, transactions, some of which are:

- Variable margins dependent on component, both vertical (product wise) and horizontal (turnover wise), segmentation,
- Predominance of royalty transactions or transfer of technology transactions as India is an importer of auto technology.
- With breakdown of Joint Ventures, transactions such as valuation of intangibles / shares will gain primacy in the times to come.
- This sector is also characterized by supply chain management issues, development of vendor network, and also has high AMP (Advertising, Marketing and Promotion) spend .
- It also has intra-group services payments as well as intra-group financial transaction like guarantees and borrowings.

3.9.1 According to DIT (Transfer Pricing), Ahmedabad, [18] Safe Harbours must take into account the different facets and segments of the auto component manufacturing market. This is important because the price/margin of an entity is also dependent upon the market segment in which the entity lies.

3.10 Considering the fragmented or diversified nature of the auto ancillary sector, the Committee is of the view that only auto ancillary units engaged in manufacturing and exporting auto components should be covered under Safe Harbour.

3.10.1 Further, since the purpose of Safe Harbour provisions is to provide certainty to taxpayers located in India who are generating economic activities in India, the Committee is of the view that Safe Harbour should not be available at the entity level but at the transaction level. The eligible transactions would thus be manufacturing and exporting of auto components by the taxpayer.

3.10.2 The Committee is of the view that no Safe Harbour need be recommended for royalty payments made by the Indian enterprises as the royalty rate would depend on so many factors such as:

- Type of technology / technical-know transferred
- The uniqueness of technology / technical know-how
- The period during which the uniqueness would continue
- The availability of alternatives
- The duration of the contract
- The role of technological obsolescence
- Making available the improvement
- Extent of indigenization

3.10.3 In view of the above factors, it is apparent that the payment of royalty and also its rate would depend on unique facts and circumstances of the individual case requiring a specific FAR analysis.

[18] Annexure III

3.11 The office of DGIT (International Taxation) provided the data on the value of international transactions, margins shown by the assessee and margins adopted by the TPO. This data is placed at **Annexure-X** and is referred to as First Set hereinafter. The First Set of data could not be used directly due to the following reasons:

- The data is mixed and includes Transfer Pricing adjustments made in the automobile sector. Hence, it is not representative of the auto components sector.
- The Committee has segregated, product-wise, the auto component industry into core and non-core as mentioned above. This segregation was not considered by the TPO while finalising the TP proceedings for the AY 2009-10 or earlier years.
- Even though the Committee did segregate the assessees into core and non-core based on their product profile, similar analysis could not be carried out for the comparables due to non-availability of their data.
- Use of incomplete data, in the view of the Committee, will create an uncertain situation and distort the comparability analysis.

3.11.1 Due to these inadequacies regarding the integrity of the above data (First Set), the Committee did not use the same while arriving at its recommendations on Safe Harbours.

3.11.2 Subsequently, data was received from the office of the DGIT (International Taxation) on the set of comparables identified by Transfer Pricing Directorate-I, Delhi, for the auto ancillaries sector (**Annexure – XI**). The mention of the fact that the core and non-core components manufacturers earn different margins (para 3.7.9 above) is also evidenced by the analysis carried out by the Committee on this subsequent data (referred to as Second Set hereinafter) received from the office of the DGIT (International Taxation). From the analysis it was found that the margins of independent companies

engaged in manufacture and sale of core auto components tend to be higher than that of non-core auto components. The analysis can be seen at **Annexures XII & XIII**. The Committee has done this detailed analysis with the help of Prowess and Capitaline databases and the annual reports of the companies, wherever required and available. The classification of these comparable companies has been made by the Committee as per the decision of segregating the sector into core and non-core auto components. This segregation is based on the products of these companies contributing predominant (>75% of sales) revenues, data available in these databases and annual reports. The sample size is fairly robust and relatively large. It also includes core and non-core auto component manufacturers. Export earnings filter / criteria has not been applied in the Second Set of independent companies, nor in the First Set of companies considered by the TPOs, which has not been used by the Committee for the reasons given in para 3.11 above.

3.11.3 The Committee also assumed that the Second Set of independent companies for the F.Y 2008-09, relevant for the A.Y 2009-10, are engaged in manufacture and sale of auto components even during the subsequent financial years , i.e., 2009-10, 2010-11 and 2011-12. Further, the Committee also made a reasonable assumption that these independent companies, which are predominantly engaged in manufacture and sale of core and non-core auto components, continue to be engaged in the same sub-segments (core or non-core) even during the subsequent financial years. Based on the above, the margins of Second Set of comparable companies for the FY 2009-10, 2010-11 and 2011-12 based on Prowess database are placed at **Annexures XIV & XV**

3.11.4 The Committee also took note of the report dated August 2007 of the earlier Committee under the Chairmanship of the then DIT (Transfer Pricing), Delhi wherein sectoral analysis of PLI (OP/Sales) of auto ancillaries located in Delhi (sample size was 14) showed range of margin from 2.99 to 22.11 %

(Page 97 of the report). But this report did not make a distinction between core and non-core auto components and is also outdated now.

3.11.5 In the view of the Committee, different margins for export of auto components need to be prescribed for core and non-core auto components separately, as they are distinguishable and at different ends of the value chain. The margins in respect of core components tend to be higher than non-core components.

3.11.6 There is a view within the Committee that Safe Harbour margins must recognise the following factors, which support outsourcing of manufacturing auto components to India:

- The outsourcing of auto components to India provides a competitive advantage to its parent in terms of costs and professional competence arising due to locational advantage. India has unique location-specific intangibles such as skilled workforce, and lower costs.
- In addition to the above, the issue of market premium also needs to be factored in.

3.11.7 An alternate view within the Committee is that market premium or location savings need not be factored in. The comparables chosen for the purposes of evaluation of whether the pricing is at arm's length operate in the same location and enjoy the same market premium or location savings as are enjoyed by the auto component exporters exporting to their foreign associated enterprises. As such, once an arm's length price is worked out and is factored in, evolving a safe harbour, there is no question of incremental factoring in of market premium or location savings.

3.11.8 After considerable discussion, the Committee decided that Safe Harbours may be considered only for enterprises carrying out manufacturing and exporting auto components. For other international transactions, appropriate FAR analysis needs to be done on a case specific basis and

hence, no Safe Harbours are recommended for such other international transactions in this sector.

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PART - 4: RECOMMENDATIONS FOR SAFE HARBOUR IN THE AUTO ANCILLARIES SECTOR – ORIGINAL EQUIPMENT MANUFACTURERS

4.1 The Committee recommends that Safe Harbour provisions should be applicable to an enterprise engaged in the manufacture and export of core and non-core auto ancillaries/components to its foreign associated enterprises, being Original Equipment Manufacturers (OEMs). An enterprise eligible for Safe Harbour may be called an 'Eligible Enterprise' and the transaction eligible for Safe Harbour may be called 'Eligible International Transaction'.

4.2 The Committee recommends that the Government may consider the following while framing Safe Harbour Rules for Eligible Enterprises opting for Safe Harbour in the Auto Ancillaries/components Sector.

4.3 General Recommendations

4.3.1 The assessee should have the option of whether to go in for Safe Harbour or not for the eligible transaction and it should not be mandatory. However, Safe Harbour should not become a rebuttable presumption for an assessee who opts not to go for it and has an Arm's Length Price (ALP) below the Safe Harbour. There has to be a directive to the Assessing Officer/TPO in this regard that they can get the international transaction bench-marked but cannot force the assessee to rebut the presumed ALP.

4.3.2 Safe Harbour would not be available to an assessee whose profits are higher than the Safe Harbour margin of the eligible transaction on account of its contracted price and such an assessee cannot be assessed at the lower presumptive ALP corresponding to the Safe Harbour.

4.3.3 Safe Harbour margin recommended may be made applicable from A.Y 2013-14, for a period of two years.

4.3.4 Further, an institutional mechanism needs to be evolved so that every two to three years, the Safe Harbour rules/margins/rates are reviewed and notified in advance so that the assessees can comply with such provisions with ease.

4.3.5 If any other international transaction is otherwise eligible for Safe Harbours, for example, loan or corporate guarantee, it will continue to be an Eligible International Transaction for the purposes of Safe Harbour.

4.3.6 Safe Harbour provisions may not be applicable if the Eligible Enterprise enters into any transaction in the nature of eligible international transaction with any Associated Enterprises (AE) located in jurisdiction as notified under section 94A of the Act or any other country/territory widely perceived as a tax haven.

4.4 Recommendations on threshold

4.4.1 The existing limit of Rs. 1 crore provided under sub-rule 2 of Rule 10D was fixed more than a decade ago. This upward revision is also justified to adjust for inflation. It may be mentioned that change in monetary parameters on account of inflation factor is part of our tax policy as is evident from the fact that the monetary limit for audit of accounts of certain persons engaged in business, as provided in section 44AB of Income Tax itself, has been revised upwards from Rs. 40 lakhs to Rs. 1 crore during the corresponding period.

4.4.2 **Accordingly, the Committee recommends that the exemption from maintaining information and documentation for international transactions specified at Rs. 1 crore under sub-rule 2 of Rule 10D of the Income-tax Rules be raised to Rs 5 crore as it will reduce compliance cost for small tax payers. Tax administration will have a smaller basket for picking up cases for scrutiny facilitating optimum use of its resources.**

4.4.3 The present practice of authorizing the AO to do transfer pricing audit in select number of cases, where the aggregate value of international transactions is less than the threshold limit (Rs. 15 crore), has reduced the applicability of the threshold limit as a Safe Harbour while simultaneously diluting the effectiveness of transfer pricing audit. **The Committee, therefore, recommends that the threshold of Rs.15 crore as an administrative Safe Harbour should be specified as a statutory Safe Harbour rule itself.**

4.5 Specific Recommendations

4.5.1 In the view of the Committee, the following international transactions constitute Eligible International Transactions:

4.5.1.1 Manufacture and Export of Core Auto Ancillaries or Components

- Manufacture and Export of auto components by the Eligible Enterprise in the nature of core components, namely:

  i. Engine and Engine Parts including piston and piston rings; engine valves and parts; cooling systems and parts; and power train components.

  ii. Transmission & Steering Parts, including gears, wheels, steering systems, axles and clutches.

  iii. Suspension & Braking Parts, including brake and brake assemblies; brake linings; shock absorbers; and leaf springs.

4.5.1.2 Manufacture and Export of Non-Core Auto Ancillaries or Components

- Manufacture and Export of auto components by the Eligible Enterprise in the nature of non-core components, i.e., all components other than core components mentioned above, which may include but are not limited to the following:

i. Equipment including headlights, halogen bulbs, wiper motors, dashboard instruments and other panel instruments.

ii. Electrical parts including starter motors, spark plugs, electric ignition systems, flywheel magnetos, and other equipment.

iii. Sheet metal parts; body and chassis; fan belts; pressure die-castings; and hydraulic pneumatic.

4.5.2 Margins for Safe Harbour and the Most Appropriate Method

4.5.2.1 From the analysis of the data of the companies considered for A.Y 2009-10 **(Annexures - XII & XIII)**, it is seen that the comparable companies (Second Set) engaged in manufacture and sale of core auto components earned an arithmetical mean margin of **7.95%** on cost, whereas companies engaged in manufacture and sale of non-core auto components earned an arithmetical mean margin of **4.26%** on cost.

4.5.2.2 The relatively lower margins in F.Y 2008-09 (A.Y 2009-10) are understandable in view of the economic circumstances that existed during that year. The year 2008-09 started with a strong economy carrying forward the momentum of previous years' growth. However, towards September 2008, global recession caught up with India and the economy slowed down significantly. The Indian Automotive Industry grew by about 4% till September 2008 and, thereafter, nose-dived. The high interest rates in combination with the non-availability of funds, adversely affected the demand for vehicles, which in turn affected the auto ancillary/component industry's performance.

4.5.2.3 The sector improved its performance gradually from 2009 onwards. This is also evident from the margins earned by these companies (Second Set), as summarised below **(**details can be seen at **Annexures - XII, XIII, and XIV & XV)**:

Description	Arithmetical Mean Margin of Comparable Companies				Arithmetical Mean
	F.Y 2008-09	F.Y 2009-10	F.Y 2010-11	F.Y 2011-12	
Core Auto Components	7.95%	10.63%	11.50%	11.20%	10.32%
Non-Core Auto Components	4.26%	5.59%	6.99%	8.17%	6.25%

4.5.2.4 Subsequently, the Indian automobile industry witnessed a moderation of demand in 2012-13, notwithstanding the projections made in the Mission Plan, after the double-digit growth in sales recorded in the preceding three years. Weak macroeconomic sentiment coupled with subdued consumer confidence pulled down sales, particularly in the latter half of the year 2012-13. Domestic automobile sales grew by 6.6% in 2012 (January to November), as compared to growth of 23.20% and 26.09% during 2009-10 and 2010-11 respectively[19].

4.5.2.5 Dun & Bradstreet has prepared a comprehensive Sectoral Outlook Report on the Automobile Sector for the year 2013 [20] and its findings are summarized as follows:

- Achieving high growth rates is likely to be a major concern for the industry in 2013 but the auto industry is likely to gain considerably from the various initiatives on infrastructure development, rural focus and the improved road infrastructure. But it expects growth in both export and domestic auto sector to moderate in 2013.

- Automobile companies across segments continue to face tremendous pressure on profit margins due to rising inflation levels. Added to this are the heightened marketing costs incurred and heavy discounts offered by vehicle manufacturers (OEMs) to attract consumers to the showrooms. Going ahead, amidst rising market competition, new product launches, as

[19] Gross Turnover - http://www.siamindia.com/scripts/gross-turnover.aspx
[20] Automobile Sector Outlook 2013: Dun & Bradstreet - http://www.dnb.co.in/News_Press.asp?pid=1174

also product refreshes planned, OEMs are expected to increase their spend on marketing & promotional activities. Although commodity prices are not expected to witness steep hikes, overall cost and competitive pressures would keep the profit margins under pressure. This will also put pressure on the margins of auto ancillary industry as well, as they are dependent on the performance of these OEMs.

- While the long-term fundamentals of the Indian economy remain robust, the sluggish global environment has impacted sentiments in the domestic market in the short term.

4.5.2.6 The Committee also noted what the Heavy Industry Minister, Shri Praful Patel stated recently, [21] while talking to reporters on the sidelines of the CII annual general meeting on 4th April, 2013:

Quote:

Well, I am very keen that the issue of the auto industry on excise for SUVs gets resolved ***because we have massive slowdown and for us the auto industry is very important for our manufacturing GDP and creation of jobs****.*

Unquote

4.5.2.7 The Committee is also aware of the latest trend in this sector. In this regard, the Hindu Business Line Newspaper Report dated 19th March, 2013 [22] reported as under:

[21] The Hindu - http://www.thehindu.com/business/Industry/praful-patel-demands-withdrawal-of-additional-duty-on-suvs/article4581401.ece
[22] The Hindu Business Line - http://www.thehindubusinessline.com/industry-and-economy/we-need-at-least-100-bps-rate-cut-auto-sector/article4525602.ece

Quote:

According to SIAM, passenger car sales in India plunged to a 12-year low in February, registering a 25.71 per cent decline to 1,58,513 units as high fuel prices, interest rates and low consumer sentiments took a toll.

With just a month left for the fiscal to end, SIAM had said that it was certain that car sales would be in negative territory in 2012-13, the first decline since 2002-03, missing the earlier forecast of 0-1 per cent rise for the ongoing financial year.

Unquote

4.5.2.8 Considering the above facts, the Committee believes that F.Y 2012-13 has been a very difficult year for this sector and F.Y 2013-14 may also be likewise. As the demand in this industry is highly elastic to rates of interest prevailing in the economy, and interest rates are under pressure due to the inflationary expectations in the economy, the auto industry is going to be plagued by the same problems as those in F.Y 2008-09, like high interest rates combined with non-availability of funds on the demand side and inflation on the supply side.

4.6 The Committee, after detailed discussion and considering all the facts, came to the conclusion that separate Safe Harbour margins need to be prescribed for the core and non-core segments of the auto ancillaries industry. After analysing the data for auto components over the years 2008-09 to 2011-12 (Second Set), the Committee noticed that the average margin of these 4 years is **10.32%** for core components and **6.25%** for non-core components (reference paragraph 4.5.2.3). The Committee also noticed that there has been an upward movement of the margins over these 4 years and the margin for the latest year, i.e., F.Y 2011-12, is **11.20%** for core components and **8.17%** for non-core components. **Taking into consideration all the above facts and also that the TPOs' orders have not attained finality, the Committee recommends 12% as an all-inclusive Safe Harbour margin for transactions in**

the nature of manufacture & export of core auto ancillaries/components. Similarly, it recommends 8.5% as an all-inclusive Safe Harbour margin for transactions in the nature of manufacture & export of non-core auto ancillaries/components.

4.6.1 Besides, the Committee is of the view that Transactional Net Margin Method (TNMM) is the most appropriate method in the case of the Eligible Enterprises, i.e., manufacturers and exporters of auto components. Thus, Operating Profit on Operating Expenses is considered as the appropriate Profit Level Indicator (PLI) for Safe Harbour under TNMM.

4.6.2 The Committee understands that for computing the above-recommended margins, the method of computing the Profit Level Indicator (PLI) is of critical importance. Operating Profit Margin is the most crucial aspect for calculating the PLI. **Accordingly, the Committee recommends that "Operating Expense", "Operating Revenue" and "Operating Profit" for the purposes of calculating PLI should be defined as follows**:

- "**Operating Expense"** is the expense of the Eligible Enterprise incurred during the course of its normal operations and in connection with Eligible International Transactions for the previous year, including royalty / technical know-how fee incurred in connection with manufacture & export of auto components to AEs, depreciation / amortization expenses relating to assets used by the Eligible Enterprise but excluding interest expense, provisions for unascertained liabilities, pre-operative expenses, the loss arising out of translations of foreign currency items, extraordinary and other items not relating to the operating activities of the Eligible Enterprise for the previous year, the loss on sale of assets / investments of the company, and the effects relating to the income tax expense of the company.
- "**Operating Revenue**" is the revenue of the Eligible Enterprise earned in connection with Eligible International Transactions and during the course

of its normal operations for the previous year, but excluding interest income, the income arising out of translations of foreign currency items, the income on sale of assets or investments of the company, the refunds relating to the income tax expense of the company, provisions no longer required written back and extraordinary and other items not relating to the operating activities of the Eligible Enterprise for the previous year.

- "**Operating Profit**" is the profit earned from normal operations of the Eligible Enterprise. It is computed as the operating revenue of the Eligible Enterprise less the operating expense incurred for an accounting period.

4.6.3 If an Eligible Enterprise is into multiple activities other than Eligible International Transactions (manufacture and export of auto ancillaries/components to OEMs), then a certificate from the auditor may be prescribed to audit and certify the profitability arising under TNMM on account of the Eligible International Transactions.

4.6.4 Accounting terms used in these Rules shall be defined in accordance with generally accepted financial accounting principles in India.

4.6.5 **The Committee recommends that once Safe Harbour rules are opted for by an assessee, no margin variation benefit under section 92C(2) or any other comparability adjustment such as, capacity, risk, working capital, depreciation etc. would be permitted**.

4.6.6 To reduce compliance costs for the assessees, it is imperative that the documentation burden on the Eligible Enterprises opting for Safe Harbour is made less stringent, as compared to an assessee choosing regular TP documentation and scrutiny by the Department. Accordingly, the **Committee recommends that such an enterprise need not maintain information and documents specified in clauses (g) to (m) of Rule 10D(1) in respect of the Eligible International Transactions**.

4.6.7 The Committee clarifies that Safe Harbour rules would not give immunity from scrutiny of any international transactions other than the Eligible International Transactions that have been opted by the Eligible Enterprise to be covered under Safe Harbour.

4.7 Recommendations on Procedural /Administrative Issues.

4.7.1 An Eligible Enterprise may exercise its option for accepting the Safe Harbour for the year by filing an option form with the Assessing Officer not later than the due date for filing the Income-tax return. If necessary a new Statutory Form for exercising Safe Harbour option to be filed along with return of income may be prescribed. Alternately, the 3CEB Report should be modified to provide for indication of election of Safe Harbour option for the year along with identification of Eligible International Transactions.

4.7.2 The Committee recommends that the AO must compulsorily refer such cases to the TPO who will conduct the functional analysis to determine the Eligible Enterprise as well as the Eligible International Transaction before accepting the results of the taxpayer under Safe Harbour. Besides, there should be strict penalties if any of the eligible conditions laid down for Safe Harbour are violated by the taxpayer.

***

Annexure-I

PM sets up committee to review Taxation of Development Centres and the IT Sector, Safe Harbour Provisions to be Finalised soon

July 30, 2012

New Delhi

The Prime Minister has constituted a Committee to Review Taxation of Development Centres and the IT Sector. The Committee will engage in consultations with stakeholders and related government departments to **finalise the Safe Harbour provisions** announced in Budget 2010 sector-by-sector. It will also suggest the approach to **taxation of Development Centres.**

2. The Prime Minister had earlier set up an Expert Committee on GAAR under the Chairmanship of Dr. Partho Shome to engage in a widespread consultation process and finalise the GAAR Guidelines. The response has been overwhelmingly positive.

3. While this committee would address concerns on GAAR provisions and would reassure investors about the predictability and fairness of our tax regime, it was felt that there is still a need to address some other issues relating to the taxation of the IT Sector such as the approach to taxation of Development Centres, tax treatment of "onsite services" of domestic software firms, and also the issue of finalising the Safe Harbour provisions announced in Budget 2010.

4. Many MNCs carry out activities such as product development, analytical work, software development, etc. through captive entities in India. They exist in a wide range of fields including IT software, IT hardware, Pharmaceutical R&D, other automobile R&D and scientific R&D. These are popularly called **Development Centres**. Over 750 MNCs have such centres at over 1100 locations in India. The reason for this large concentration of Development Centres in India is the worldwide recognition of India as a place for cost competitive, high quality knowledge related work. Such Development Centres provide high quality jobs to our scientists, and indeed make India a global hub for such Knowledge Centres. However, India does not have a monopoly on Development Centres. This is a highly competitive field with other countries wanting to grab a share of the pie. There is need for clarity on their taxation.

5. As far as **Safe Harbour provisions** are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer.

6. The resolution of the above tax issues requires a comprehensive approach in which other government departments are consulted and industry bodies are taken on board. The overall goal is to have a fair tax system in line with best international practice which will promote India's software industry and promote India as a destination for investment and for establishment of Development Centres. Therefore, the Prime Minister has constituted a Committee consisting of experts from the Income Tax Department, both serving and retired, who will examine the issues in detail and submit proposals in a short time. An arm’s length exercise of this nature will allay a lot of concerns in addition to the immediate resolution of issues that is necessary.

7. For this purpose, a **Committee on Taxation of Development Centres and the IT sector** has been constituted consisting of:

1) Shri N. Rangachary, former Chairman CBDT & IRDA - Chairman

2) Ms Anita Kapur, Director General (IT) - Member

3) Ms Rashmi Sahani Saxena, DIT (TP) - Member

4) Any other officer from the Income Tax Department to be co-opted by the Chairman

8. The **Terms of Reference of the Committee** will be to:

i) Engage in consultations with stakeholders and related government departments to finalise the approach to Taxation of Development Centres and suggest any circulars that need to be issued.

ii) Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector. The Committee will also suggest any necessary circulars that may need to be issued.

iii) Examine issues relating to taxation of the IT sector and suggest any clarifications that may be required.

9. The Committee will work to the following time schedule:

i) Finalise the approach to taxation of Development Centres and suggest any necessary clarifications by **31 August 2012.**

ii) Suggest any necessary clarifications that may be needed to remove ambiguity and improve clarity on taxation of the IT Sector by **31 August 2012.**

iii) Finalise Safe Harbour Rules individually sector-by-sector in a staggered manner and submitting draft Safe Harbour provisions for three sectors/sub-activities each month beginning with the first set of suggestions **by 30 September 2012.** All Safe Harbour provisions can be finalised by **31 December 2012.**

10. The Department of Revenue will provide all necessary support to the Committee to facilitate its work including office assistance and assistance to facilitate consultations.

Annexure- II

F.No.A. 50050/103/2012-Ad.I
Government of India
Ministry of Finance
Department of Revenue
***

New Delhi, dated the 13th September, 2012.

OFFICE MEMORANDUM

Subject: Constitution of a Committee to Review Taxation of Development Centres and the IT Sector- Reg.

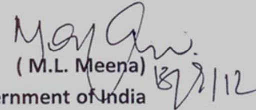
***

The undersigned is directed to refer to Department of Revenue's O.M. of even number dated 3rd August, 2012 on the above cited subject and to say that considering the paucity of adequate data required to draft the rules, the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors/activities:

(i) IT Sector
(ii) ITES Sector
(iii) Contract R&D in the IT and Pharmaceuticals Sector
(iv) Financial Transactions – Outbound loans
(v) Financial Transactions – Corporate Guarantee
(vi) Auto Ancillaries – Original Equipment Manufacturers

2. In view of the above, the revised timelines for submitting the reports on Safe Harbour provisions by the Committee have been modified as under:

First Report by 15.10.2012;
Second Report by 15.11.2012; and
Final Report by 31.12.2012.



(M.L. Meena)
Joint Secretary to the Government of India

Copy to:

1. Shri N. Rangachary, Chairman of the Committee to Review Taxation of Development Centres and IT Sector. His kind attention is invited to Notes dated 12/09/2012.
2. Ms. Anita Kapur, Director General(IT), Member of the Committee.
3. Ms. Rashmi Saxena Sahni, DIT(TP), Member of the Committee.
4. Shri Dinesh Kanabar, Tax Expert, Member of the Committee.
5. Shri B.V.R. Subrahmanyam, Joint Secretary to PM.
6. PS to FM.
7. PPS to Secretary(Revenue).
8. Chairman, CBDT.

Annexure – III

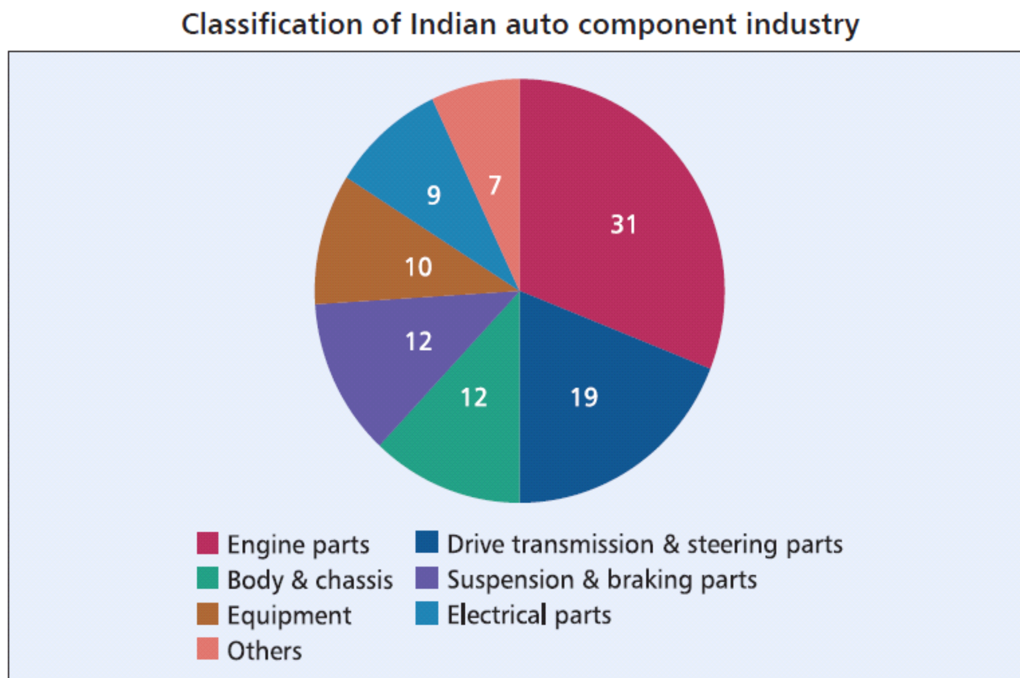
Safe Harbour rules for Automobile Sector - Note of Director of Income-tax (Transfer Pricing), Ahmedabad

Comments have been sought on the safe harbour rules to be introduced in the Indian Income Tax Act, 1961 in Automobile sector. The salient features of Indian Automotive component manufacturing market are as below:

2. An auto component industry can be segmented on the basis of the production of component types as below

- Engine Parts
- Drive Transmission and Steering Parts
- Suspension and Brake Parts
- Electrical Parts
- Equipments
- Other Parts

The relevant contribution of these types in the market segment is as follows:



Source: Annual Report FY11, ACMA

2.1 The auto component industry can also be segmented through the supply chain tierization like first tier, second tier, third tier and fourth tier as the levels of supply category and involvement in the supply chain of automobile company. The fourth tier suppliers supplies raw material as a small jobs while a second tier suppliers produces a full auto component. The first tier suppliers are identified as a OEMS/ Assemblers (Original equipment manufacturers). There are new direct suppliers, who design systems and coordinate almost the entire chain encompassing the manufacturing and assembly process and these are the Tier 1 and 0.5 who have major involvement as a supplier in manufacturing of automobiles, they provide semi – assembled modules of automobiles like steering system, rear axle system etc. which can be directly fixed on the final assembly of the cars.

2.2 The market for automotive components can be segmented into three categories based largely on the identity of the buyer:

- Original Equipment Manufacturers (OEMs - the vehicle manufacturers)
- Replacement (vehicle owners who buy parts for maintenance and repair)
- Exports (primarily foreign vehicle manufacturers and International Tier I suppliers).

<u>OEM SEGMENT</u>

2.2.1 The principal drivers of demand for the automotive components industry from the OEM segment (in number terms) are passenger cars and commercial vehicles. While OEMs are an assured source of demand for component manufactures, the OEMs also exert a great amount of pricing pressure on the component suppliers. It is the relatively large order size of the OEMs that gives them the bargaining strength.

<u>REPLACEMENT MARKET</u>

2.2.2 The huge unorganised sector typically caters to the demands from replacement market. The unorganised sector in turn is a low-cost one with the fiscal liabilities (in terms of excise duties) being not accounted for by this sector. As a result, this sector is able to supply the replacement market with significantly lower-priced parts vis-a-vis those produced by the organised sector. The after-market is highly competitive for components with a high price elasticity of demand and a tolerance of lower quality standards. A major channel of marketing and distribution for this sector is the typical roadside mechanic. The automotive component supplier also caters to the demands from the replacement market, apart from the original equipment one. *<u>Additionally, for automotive component suppliers, the prices in the</u>*

replacement market are relatively higher than the prices in the original equipment market. This higher prices in the replacement market is because of the higher margins charged by the component suppliers, the impact of a longer supply chain and the tax structure. Typically, the replacement market provides higher margins but lower volumes vis-a-vis the OEM market.

Five factors primarily influence the aggregate annual demand for replacement parts:

- Size of the national vehicle population
- Average age of the national vehicle
- Pollution norms and Government regulations
- Average number of kilometres driven per vehicle
- Road and other related conditions.

EXPORT MARKET

2.2.3 International automotive players with operations in India are increasingly sourcing components from Indian automotive component manufacturers. For instance, Hyundai and Fiat are sourcing parts locally for their Santro and Palio models in India, respectively. The demonstrated ability of Indian component makers to make supplies to global automotive manufacturers in the country has opened up the possibility of the component makers supplying the same OEMs in other countries as well.Indian component manufacturers continue to enjoy competitive advantages primarily on the strength of the following factors:

- Low labour costs (low labour costs pulls down the total cost of production, typically in assembled parts such as clutches and lighting equipment). For instance, wage rates in India are currently 60% cheaper than that in developed markets. Dana Corp probably spends close to 39% of revenues on wages, as opposed to 6-7% by Indian forging company, Bharat Forge.
- Less stringent environmental regulations (environmental regulations have rendered the production of parts like castings cost prohibitive in developed countries). For instance, the metal casting process generates dust and it is estimated that foundries in Europe and USA on account of stringent environmental compliance spend roughly 5-

6% of their sales on pollution control. Such costs are almost negligible in countries like India and other Asiatic nations.

- Low minimum economic scales and possession of established technology (as in castings and forgings).

Given these competitive advantages, India is therefore widely regarded as having an advantage in terms of low labour costs, strong engineering skills, and machining and processing capabilities.Hence, labour intensive and assembly-oriented components are likely to be sourced from India. The exports of the automotive component manufacturers are targeted at the following groups of buyers:

- International vehicle majors such as Volkswagen, Volvo and so on. Exports are largely to their operations in developing countries since these manufacturers do not find it cost effective to source components from their own plants or from other local units. For instance, domestic component manufacturers such as Bharat Forge, Rico Auto, Sundaram Fasteners supply directly to global OEMs.

- Vendors who supply to component manufacturers like Delphi, Dana Corporation and Valeo. As an example, recognising the cost advantage involved, most global OEMs such as Ford, General Motors and Volvo, and Tier-I companies such as Navistar and Cummins have set up international purchase offices in India, to source components and export them to their global plants.
- Many global automobile manufacturers have identified India as a manufacturing base for some of their models, which are then exported to other countries. For instance, in the passenger car segment, Hyundai's Santro Xing and Suzuki's Alto are being exported. Two-wheeler manufacturers Yamaha Motors and Honda Scooters are also exporting some of their models. Similarly, Indian OEMs such as Bajaj Auto (World Bike 125 cc), TVS Motors and car companies such as Tata Motors (City Rover) and M&M (Scorpio) are also exporting fully built vehicles. As components form more than 50% of their cost of manufacture, the export of vehicles increases the demand for domestic auto components.
- The replacement market, which accounts for a large proportion of the exports of components from the Indian market. This is due to the fact that a significant portion of the Indian components is exported for the replacement markets for out-of-production models in these countries. As Tier-I vendors located in these countries meet the demand for current models,

the production of components for out-of-production models are outsourced to countries like India. Additionally, Indian component manufacturers are also dependent on this market for the following reason:

- Unlike the OE market, the replacement market has low volumes and high margins. The OE market in turn, although has very large and assured volumes, the pricing is very stringent and strict quality controls are in place. As a result, Indian component manufacturers in the past and even now are exporting to the replacement market.

3 The reason and rationale for discussing the above mentioned facets of Indian auto mobile component manufacturing market is to underline the importance of the industry segment in which the assessee pertains to. Consequently, the adoption of safe harbours is required to take into account the different facets and segments of the auto mobile component manufacturing market. This is important because the price/margin of an entity is also dependent upon the market segment in which the entity lies.

4. Further it is important to note that in the above discussion, the industry pertaining to automobile component manufacturers has been discussed and the automobile manufacturers have not been discussed at all.

5 The details of the entities engaged in such activities in this Directorate have already been submitted earlier.

Annexure – IV

Note from Society of Indian Automobile Manufactures (SIAM)

Society of Indian Automobile Manufacturers *SIAM*

A Note on Transfer Pricing by SIAM

Introduction:

The provisions relating to the Transfer Pricing contained in the Income tax law of India do not provide the detailed guidelines on the practical applicability of the provisions. The transfer pricing laws in many countries like US, Australia etc provide detailed guidelines and examples to be followed by the Tax officers as well as assessees for implementing transfer pricing laws.

A detailed transfer pricing guideline should be prescribed in India which would go a long way in removing ambiguities for both the tax-officers as well as the assessees and reduce litigation burden in the country. For instance companies using foreign brand name of the AE, the revenue authorities have been disallowing large part of advertisement and marketing expenditure incurred in India claiming it to be expenses incurred for creating marketing intangible for the foreign AE. AMP expenditure paid to unrelated parties does not come under international transaction as per section 92B of the Income Tax Act 1961. AMP expenditure is incurred on own account – Benefit if any to Foreign company is purely incidental.

In this situation if it is clarified by way of guidelines and examples situations in which this will be taxed as marketing intangible in India, it will go a long way in bringing certainty in this matter thus also creating a conducive atmosphere for foreign investment. Generally accepted international guidance on this should be followed unless there is any specific reason to deviate. In case of companies holding exclusive long term licenses to manufacture and sell in India no such additions for AMP can be made based on international guidance on the matter and this should be clarified in Indian guidelines to be made.

Similarly guidelines should be laid down that the composite indivisible royalty can be tested for arms length under TNMM method at an entity level only as type of technology and extent of technology imported by each company is different and CUP method cannot be applied. The import prices for components imported from AE to whom royalty is paid are also different from company to company depending on the technology and margins and that is another reason why CUP should not be applied to test arms length nature of royalty expense.

With an increase in the number of International Transactions, the Transfer Pricing norms and the Transfer Pricing Law are seeing a rapid change. It is observed that, the Transfer Pricing assessments are being used as the most Revenue Generating scheme for the Government. For monitoring of the Transfer Pricing Transactions the provisions U/s 92 to 92F have been enacted with a view to provide a framework which can lead to computation of reasonable, fair and equitable pricing which affects taxation in India.

Thus, any income/expenditure from international transaction has to be computed having regard to the Arms Length Price (ALP).

There are various methods incorporated to settle down on the ALP. But, still Transfer Pricing is in its infancy and there are certain lacunas which need to be addressed. In this relation below points are suggested;

One authority to decide the Arm's Length Price (ALP) for both Direct and Indirect Taxes (both of which comes under the Department of Revenue of Ministry of Finance):

It is suggested that there should be a single authority to decide the ALP of a transaction so that the same price can be used for various judicial requirements. Customs and the Income Tax departments are having opposite ends to meet. While the Customs department doubts that the import price is 'undervalued', the Income Tax department doubts the same as 'overpriced'. Finally the assessee gets the hit from both the ends. Thus, may it be any arm of the Government, the price to be adopted should be the price determined by this single authority.

To support this view we may rely upon the following:

Circular No-6-P dated 6-7-1968, in which sr. no 74 which reads as

> *"---- In regard to the latter provisions, the Deputy Prime Minister and Minister of Finance observed in Lok Sabha (during the debates on the Finance Bill, 1968) that where the scale of remuneration of a director of a company had been approved by the Company Law Administration , there was no question of the disallowance of any part thereof in the income –tax assessment of the company on the ground that the remuneration was unreasonable or excessive."*

Thus, the circular, as aforementioned, suggests that the decision by one arm/ wing of the Ministry of Finance should be accepted by the other arm.

There are also judicial presidents to support this view, like the one below;

Kinetic Honda Motor Limited V Joint Commissioner of Income Tax- 2001-(072) TTJ-0072-TPUN,

The TPO should incorporate some of the characteristics of the APA mechanism to make the TP assessment more meaningful and successful.

a. **Enough time for a proper assessment:**

The tax return for a given financial year is filed by Dec. of the following assessment year, leaving 37 months to the TPO to do his assessment. But typically the assessments are conducted within the last 6 to 8 months, most of the time giving just few days (less than a week) to the assessee to respond to the queries / show cause notices.

b. **Interactive Dialog:**

The TPO should have a dialogue as to the method and comparables used in the TP review report, discuss mutually and required to have a revised / altered / new study to arrive at proper comparables. This will avoid basic disputes, like captive unit compared with normal business units, comparison of controlled transactions, corporate guarantee / loan given to an AE compared with a banking company, etc.)

c. **No Cherry Picking:**

While finalizing ALP, the Major drawback is that the loss making companies are not considered at all although it is normally settled that new companies, companies going through economic / product cycle etc. are loss making in their initial / interim phases.

Therefore, the companies chosen for the comparison should not be by cherry picking.

Determination of Comparable and choosing an appropriate method for determination of the ALP.

The biggest hurdle in the provisions of Transfer Pricing laws is the determination of the proper comparables. Due to non-availability of data and non- availability of the comparables there is a remote possibility of selecting a proper comparable. Depending on the comparable selected, finally depends the method of determination of ALP.

Therefore it is suggested that there should be concrete and specific directions to select the "Comparable" (which are not controlled ones and the adjustments that may be required based on the FAR analysis). Countries like USA, UK, Germany, France, Japan, Singapore and Netherlands have detailed guidelines, including that for intangibles. Further use of multiple year data should be permitted. Multiple year data captures market/business cycles and smoothen the effects of yearly aberrations, giving good results statistically. Lack of specific guidance on selection of comparable leads to wrong selection of ALP Method.

No clarity in benchmarking.

Since there is no specific provision to guide the benchmarking, this step becomes more critical. There should be specific provisions illustrating the proper and specific steps to taken in the benchmarking process. Even though there are provisions to adjust based on the FAR analysis, the same is not practiced during the assessments.

Giving greater authority and responsibility to the TPO

Giving greater authority under the TP assessment provisions and at the same time making the TPO responsible for frivolous adjustments is expected to yield more sincere and meaningful assessments.

Filing of tax return and transfer pricing report by foreign companies

Facts

As per section 139(1)read with section 5 of Income Tax Act, every person (which includes foreign Company)having income accrued or received in India, has to File income tax return in India, even if does not have permanent establishment in India.
As per section 92D read with section 92E every person (which includes foreign company) who has entered into international transaction, shall maintain transfer pricing documents and shall file TP (transfer pricing) certificate with tax authorities.

Indian Company is deducting TDS from taxable payments to Foreign Company and TDS return with all details is filed with tax authorities. Indian company is also filling TP certificate with all detail of transactions with Foreign Company with tax authorities

Suggestion

It is irrational to burden foreign companies to file TP report and Income Tax return for similar transactions already reported by Indian Company and on which due tax has already been deducted by Indian Company. In other countries also it seems that foreign companies are exempted from such compliances
In our view, unless foreign company has a Permanent Establishment in India, in respect of incomes earned from India, the foreign company shall not be required to file TP report relating to Indian Transfer Pricing regulations and filing of tax return with tax authorities in India
Provisions can be made that foreign companies shall be exempted from filling income tax return and TP certificate with tax authorities.

Applicability of Domestic Transfer Pricing provisions

Transfer pricing provisions were made applicable to domestic related party transactions by Finance Act, 2012. The provisions were inter-alia made applicable to all transactions (*where aggregate of such transactions is above Rs.50 Mln*) covered u/s 40A of the Income tax Act, 1961. A large number of transactions between domestic related parties covered under Sec.40A involves parties who are subject to similar tax rates/status, where the applicability of these provisions is unwarranted as, even if some mis-pricing was assumed, there was no loss to the revenue on an overall basis. In such cases, the applicability of these provision significantly adds to the administrative burden of the Income Tax department as well as the assessees without proper justification.

The TP provisions on domestic transactions do not allow for a corresponding set-off of TP adjustment made in one party in the other related party, which is unjustified considering that both parties are under the same tax-jurisdiction. It amounts to taxing the same income twice i.e. in the hands of both the related parties.

Appropriate amendments should be made to the above provision exclude cases where both the related parties are under similar tax-status and/ or allow corresponding set-off of TP adjustment made in party to the other related party.

Constitution of Dispute Resolution Panel (DRP)

The Dispute Resolution Panel (DRP) has so far been mostly an ineffective institution in resolution of transfer pricing disputes. It should be re-constituted as an independent body similar to the proposed "Approving panel" under the GAAR scheme which is proposed to be comprised of 3 members including a Chairperson being current or retired HC judge, a Chief Commissioner of IRS and an independent academic expert in tax/business matters.

This will lend a lot of credibility and independence to the DRP and help to achieve the objective for which the DRP was originally set up i.e. for faster resolution of Transfer pricing disputes.

Annexure – V

Office Memorandum of Department of Heavy Industry

भारत सरकार
GOVERNMENT OF INDIA
भारी उद्योग एवं लोक उद्यम मंत्रालय
MINISTRY OF HEAVY INDUSTRY & PUBLIC ENTERPRISES
भारी उद्योग विभाग
DEPARTMENT OF HEAVY INDUSTRY
(AEI Section)

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उद्योग भवन
Udyog Bhavan
नई दिल्ली
New Delhi-110011

Ref. No.4(2)/2013-AE-I

Dated: 20th March, 2013

Office Memorandum

The undersigned is directed to refer to D.O letter No. DIT/TP-I/89/Delhi/2012-13/1006 dt. 25.02.2013 from Mrs. Rashmi Saxena Sahini, Director of income Tax (Transfer Pricing)-I, addressed to Secretary, DHI enclosing therewith a D.O letter dt. 10.12.2012 of Shri N. Rangachary, Chairman, and Committee to Review Taxation of Development Centres and IT Sector seeking DHI views on the issue of having a Safe Harbour in respect of Original Equipment Manufacturers in the Auto Ancillaries sector.

The views of industry representatives i.e. SIAM have been taken on the issue. It is understood that SIAM has already furnished their views in the matter to Directorate of Income Tax (Transfer Pricing)-1, however a copy of note on transfer pricing by SIAM is enclosed herewith.

SIAM has informed that the provisions relating to the Transfer Pricing contained in the Income tax law of India do not provide the detailed guidelines on the practical applicability of the provisions and suggested that a detailed transfer pricing guideline should be prescribed in India which would go a long way in removing ambiguities for both the tax-officers as well as the assessees and reduce litigation burden in the country. For instance AMP expenditure paid to unrelated parties does not come under international transaction as per section 92B of the Income Tax Act 1961. AMP expenditure is incurred on own account.In case of companies holding exclusive long term licenses to manufacture and sell in India no such additions for AMP can be made based on international guidance on the matter and this should be clarified in Indian guidelines to be made.

SIAM has further suggested that guidelines should be laid down that the composite indivisible royalty can be tested for arms length under TNMM method at an entity level only as type of technology and extent of technology imported by each company is different and CUP method cannot be applied. The import prices for components imported from AE to whom royalty is paid are also

different from company to company depending on the technology and margins and that is another reason why CUP should not be applied to test arms length nature of royalty expense.

SIAM has informed that at present the Transfer Pricing assessments are being used as the most Revenue Generating scheme for the Government whereas transfer pricing is still in its infancy and there are certain lacunas which need to be addressed. Also SIAM has suggested the following measures for addressing the issues-

(i) There should be a single authority to decide the ALP of a transaction so that the same price can be used for various judicial requirements.

(ii) Enough time should be given to assessee to respond to the queries / show cause notices.

(iii) The TPO should have a dialogue as to the method and comparables used in the TP review report, discuss mutually and required to have a revised / altered / new study to arrive at proper comparables.

(iv) While finalizing ALP loss making companies are not considered. It is normally settled that new companies, companies going through economic / product cycle etc. are loss making in their initial / interim phases. Therefore, the companies chosen for the comparison should not be by cherry picking.

(v) The biggest hurdle in the provisions of Transfer Pricing laws is the determination of the proper comparables. Due to non-availability of data and non- availability of the comparables there is a remote possibility of selecting a proper comparable. There should be concrete and specific directions to select the "Comparable" (which are not controlled ones and the adjustments that may be required based on the FAR analysis) as is being done in countries like USA, UK, Germany, France, Japan, Singapore and Netherlands which have detailed guidelines, including that for intangibles.

(vi) There should be specific provisions illustrating the proper and specific steps to taken in the benchmarking process. Even though there are provisions to adjust based on the FAR analysis, the same is not practiced during the assessments.

(vii) The TP provisions on domestic transactions do not allow for a corresponding set-off of TP adjustment made in one party in the other related party, which is unjustified considering that both parties are under the same tax-jurisdiction. It amounts to taxing the same income twice i.e. in the hands of both the related parties. Appropriate amendments should be made to the above provision to exclude cases where both the related parties are under similar tax-status and/ or allow corresponding set-off of TP adjustment made in party to the other related party.

(viii) The Dispute Resolution Panel (DRP) has so far been mostly an ineffective institution in resolution of transfer pricing disputes. It should be re-constituted as an independent body similar to the proposed "Approving panel" under the GAAR scheme. This will lend a lot of credibility and independence to the DRP and help to achieve the objective for which the DRP was originally set up i.e. for faster resolution of Transfer pricing disputes.

(Niraj kumar)
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Note from S.R. Dinodia and Company in respect of the Auto Ancillaries Industry in India

I. Indian Auto Industry

The Indian Auto industry is transforming itself from a low volume, highly fragmented one into a competitive industry, and backed by competitive strength, technology and transition up the value chain. Auto industry is a very wide arena and includes entities that are engaged in manufacturing various ancillary parts like seat belts, engine parts, lighting parts, etc for automobile manufacturers.

Broadly the Indian Auto Industry can be divided into the **automotive sector and the auto component sector.**

The forte of the Auto Industry is constantly evolving and innovative technology that meets the demands of a highly competitive market. The major product offerings in the automotive sector are passenger motor vehicles, commercial vehicles – HCV/LCV, two wheelers and three wheelers. A comprehensive structure is presented on slide no. 11 of the attached pdf report.

It may be said that the auto component industry comprises of mainly Engine & Engine Parts, Transmission & Steering Parts, Suspension & Braking Parts, Equipment, Electrical Parts, Others like sheet metal parts, chassis, die castings etc. A comprehensive structure of auto component is also presented on slide no. 12 of the attached pdf.

Out of the above industries in auto sector, it may be said that some of the components are core to the automobile without which it cannot run. The automobile ancillary market could be bifurcated in the core components and the non-core components. Broadly, the components of engine and engine parts, Transmission & Steering parts and Suspension & Braking Parts should be covered in the core components. The rest of the components are part of non-core.

Core components are those that require complex technology and functions in the process of manufacture and these components would form the heart of the automotive. Example, a car can't run without an engine, clutch, and gears however it can run without mirror and door latches which are non core activities.

A company manufacturing engine parts which is a core component requiring complex functions, high investment in assets and therefore bears a high risk, usually gets remunerated by an automotive manufacturer better than those manufacturing non-core components such as lights, switches, mirrors, etc. It is like comparing the heart with the eye.

The profitability of the industry would depend upon the functions performed, assets utilized and the risks borne in each segment of the auto ancillary industry. A person would ready to pay more to the manufacturer performing complex functions producing a core component than the person dealing in non core components. As per settled principle, more risk and more reward. A person undertaking manufacturing of core activities will expect more return.

Based on the above philosophy, we have run a search process in order to find out the companies in the automotive industry and auto ancillary industry and the search has been conducted separately for core as well as non-core components. During the search process we have selected those companies, for which data is available as on 31st March, 2012.

A. **Core Functions/ Activities**

We have selected the companies engaged in the below mentioned industries:-

like '%Auto Ancillaries - Axles / Shafts%'
like '%Auto Ancillaries - Brakes%'
like '%Auto Ancillaries - Clutches%'
like '%Auto Ancillaries - Engine Parts%'
like '%Auto Ancillaries - Gears%'
like '%Auto Ancillaries - Shock Absorbers%'
like '%Auto Ancillaries - Wheels%'
like '%Automobiles - LCVs/HCVs%'
like '%Automobiles - Motorcycles / Mopeds%'
like '%Automobiles - passenger cars%'
like '%Automobiles - Scooters and 3-Wheelers%'
like '%Automobiles - Tractors%'

The above search filtered 57 companies. Further the core activities in auto industry can be classified into three segments as follows:-

- Automobiles
- Auto Ancillary- Gears

- Other core activities

Then we have refined our search by removing the outliers having abnormal loss or abnormal profit in that respective industry then calculated the average profit level indicator of the companies. The detailed PLI Calculations are as per attached excel file, which shows in the Auto Ancillary space the gear making companies earn the maximum margin (Avg. 12%), the other core component manufactures earn an average of 7% or more while the non core component manufactures earn on average 5% or below.

It is to be noted that we have calculated the normal margins based on the figures available on the face of the profit and loss account without considering the other factors like functions performed, assets employed and risk assumed and we have not done any analysis on operating and non operating nature of each expenses.

B. <u>Non Core Functions/ Activities</u>

Same way we have run a search process to find out the average margin of companies engaged in non core activities/ functions in auto sector.

We have selected the companies engaged in the below mentioned industries:-

like '%Auto Ancillaries - Batteries%'
like '%Auto Ancillaries - Electrical%'
like '%Auto Ancillaries - Friction Materials%'
like '%Auto Ancillaries - Lamps%'
like '%Auto Ancillaries - Others%'
like '%Auto Ancillaries - Plastic Mouldings%'
like '%Auto Ancillaries - Sheet Metal%'
like '%Auto Ancillaries - Springs%'
like '%Auto Ancillaries - Trading%'

The above search filtered 73 companies. Then we have refined our search by removing the outliers having abnormal loss or abnormal profit in that respective industry. After exclusion of 19 outliers, we have calculated the average margin and which turned 5.52% (PBT/Total Expense). Excel attached.

It is to be noted that we have calculated the normal margins based on the figures available on the face of the profit and loss account without considering the other factors like functions performed, assets employed and risk assumed and we have also not done any analysis on operating and non operating nature of each expenses.

II. Distinction between Royalty and Fees for Technical Services and why there is not overlap between the two.

Licensing may be defined as an arrangement between two parties, where one party has proprietary rights over some information, process, or technology protected by a patent, trademark, or copyright. This arrangement, specified in a contract, requires the licensee to pay a royalty or some other specified sum to the holders of the proprietary rights (licensor) in return for permission to copy the patent, trademark, or copyright. It is concerned with granting rights to use commercially valuable intellectual property.

License is an indivisible, non transferable right and without the right to grant sub license to manufacture, assemble and sell the products for automobiles. Royalty is paid for the license granted.

It would be incorrect to hold that if a person is paying royalty for license, then he will get the technical support and guidance from the licensor free of cost. Basically royalty is for the license to use a particular technology, however technical know how fees and technical guidance fees is related to the information of how to use the technology in a better way. In automobile industry, Indian company pays royalty for the license granted by the foreign company and in addition to the agreement for payment of royalty it also enters into agreement with the foreign company for technical support and guidance and for which it pays technical know how fees and guidance fees.

Under the agreement, the foreign company sends their employees for technical guidance, training and support for which Indian Company pays technical guidance fees.

Mere grating of license does not itself provide the way of using that license. A person would always be in the need of continuous support and guidance in order to update the knowledge and to know the better use of the license. Hence, grant of license and continuous guidance would be separate transactions for which they have entered into separate agreements. Therefore, both the transactions have separate relevance and these two can not be combined in order to see as a one transaction.

Annexure-VII

Note from Confederation of Indian Industry (CII)

Confederation of Indian Industry

I. Suggestions regarding Safe Harbor provisions for the auto ancillaries sector

General

Transfer Pricing provisions, generally being anti-avoidance in nature, contains a certain amount of rigor with considerable onus on the tax payer. Such a rigour may create bottlenecks in the environment to do the business due to static nature of the law. The rigid provisions in the transfer pricing provisions especially impact the automotive industry which is cyclic in nature and depends considerably on technology and knowledge base available outside India.
Outside India, the International Transfer Pricing regulations have been practiced for many years. Over the years most of the international transfer pricing jurisdictions have taken many steps to make the transfer pricing process more judicious for the taxpayer. Such steps are as under:

a) Transparent guidelines regarding methods.
b) Advanced Pricing Arrangements.
c) Mutual Agreement Procedure (MAP)

The Safe Harbour provisions are intended to work in situations where, considering the taxpayer's facts and the country situation, the above measures are not sufficient to substantiate the tax incidence on a judicious basis.

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There is need for formulating an appropriate mechanism which would address the realistic difficulties faced by the Indian tax payer with regard to the Safe Harbour provisions. In other words, Safe harbour provision cannot be taken as substitute for transparent transfer pricing mechanism.

Certain important suggestions on Safe Harbor Regulations

- **Comparability**

  Inter-quartile range should be adopted in place of arithmetic mean, as the inter-quartile range indicates the distribution/ spread in which "normally" (i.e. under non-influenced circumstances) one person falls if other circumstance of industry and level of operations are same/ similar. Inter-quartile range, being a reflection of the "normal distribution" automatically rejects the unreasonable or extreme results. On the contrary the arithmetic mean is a point which would never be achievable by any independent business, even if the industry and level of operations are same. This is because there would be finer differences like availability of own space as against leased premises, etc which will impact the profitability and in turn will not be achieved in th mean".

- **Range of mark up and similar assertions**

  The Indian Automotive Industry is subject to severe competition, both in the domestic and international markets. Hence, the transactions with Associated Enterprise (AE) for sourcing or selling the components (with a view to leverage the resource base) are increasing.

  The Automotive Industry depends on know-how and other intangibles for the design and innovative automotive systems. The transactions of technical knowhow or technical services are significantly increasing. There is an opportunity for India to leverage its large knowledge base.

In the above situations, the advance pricing arrangements may not provide sufficient solution in each case. The safe Harbour provisions could support the following:

a) Ranges percentage of mark-up over the total cost in respect of transaction involving sale or purchase of components.

b) Range of rates for royalty or towards use of technical know-how.

c) Indian automotive industry is availing services from Foreign AEs as technology in Europe, America and Japan is more advanced than in India. Further, such services are purely for the benefit of development and for nurturing the Indian automotive industry. Hence, Safe Harbour provisions should fix a mark-up of around 12.5% to15% for such transactions towards payment for technical services.

- **Intangible asset valuation**

  There are a range of assumptions for valuation of intangibles in terms of product life cycle and EBITDA earnings. These assumptions are critical and most litigated and should be re-considered.

- **Distribution mark-up in India**

  Distribution of vehicles or components or parts is a routine function. To reduce the burden of compliance cost in respect of such routine transactions, we may fix a mark-up of around 1 – 2% of the value of vehicle or 10% over the value added cost as the safe harbor mark-up

- **Exports**

  a) In order to promote the competiveness of Indian automotive industry in the international markets, the Safe Harbour provisions should prescribe a reasonable range of margin on exports to AE. This should be over and above the APA mechanism.

There should be similar guidance on the percentage of commission on exports

II. Transfer Pricing Issues & Recommendations for Auto ancillaries

The auto ancillaries sector in India consists of original equipment manufacturers (OEM), contract manufacturers and trading companies

It has witnessed that different types of automotive components govern a different rate of return. Hence, the application of differential safe harbours to different categories of auto ancillaries may be considered, although generally, a net operating **profit margin/return of 3-5 percent** from manufacturing activities may be considered to adequately compensate for the functions and risks normally undertaken by an OEM. Some issues and suggestions pertaining to differential safe harbour are as under:

Issue

1. Variation in business cycles - not given due cognizance

Explanation

- Demand in the auto industry is heavily dependent on the economic situation and circumstances.

  Market / business cycle variations may not always be reflected in the financial statements of the comparable companies.

Remark/suggestion

Losses on account of lower business volumes and slack in demand must be determined and factored while assessing taxpayers' operating margins

Issue

2. Taxpayers' claim for adjustment on account of under utilized capacity - rejected in most cases.

Explanation

In most cases, auto ancillary production units operate at less than optimum capacity and due to such under-utilization of capacity the fixed overhead cost remains unabsorbed

Remark/suggestion

- Unabsorbed fixed cost should be treated as 'non-operating' item of expense.
- Components of fixed costs must be determined depending on facts and circumstance of each taxpayer's case.

Issue

3. Payment of royalty / FTS – disallowed on the pretext that benefits to the taxpayer are not identifiable

Explanation

- Indian affiliates normally require assistance in the form of technology & know-how, technical assistance, training for use of imported technology etc.
- In many cases, Indian affiliates may also require technical guidance in relation to specialized processes in manufacturing etc

Remark/suggestion

- Quantification of direct benefits would not be possible in most cases, since every penny incurred for the business may not have a directly identifiable benefit / outcome.
- Cost may even be incurred for attaining competitive edge or even smooth functioning of business operations.
- Nature of business operation and extent of dependence on technology and technical assistance should be given due cognizance and hence payment

for use of technology or IP needs to be accepted since the IP owner incurs huge cost on research and development.

III. Transfer Pricing Issues: Arms Length Price (ALP)

Introduction

The provisions relating to the transfer pricing contained in the Income tax Act do not provide the detailed guidelines on the practical applicability of the provisions. The transfer pricing laws in many countries like US, Australia etc provide detailed guidelines and examples to be followed by the tax officers as well as assessees for implementing transfer pricing laws.

A detailed transfer pricing guideline should be prescribed in India. This would go a long way in removing ambiguities for both the tax-officers as well as the assessees and reduce the burden of litigation in the country. For instance, for companies using a foreign brand name of the AE, the revenue authorities have been disallowing a large part of advertisement and marketing expenditure incurred in India claiming it to be expenses incurred for creating marketing intangibles for the foreign AE. AMP expenditure paid to unrelated parties does not come under international transaction as per section 92B of the Income Tax Act 1961. AMP expenditure is incurred on own account - benefit if any to foreign company is purely incidental.

In this situation if it is clarified by way of guidelines and examples, situations in which this will be taxed as marketing intangible in India, it will go a long way in bringing certainty in this matter thus also creating a conducive atmosphere for foreign investment. Generally accepted international guidance on this should be followed unless there is any specific reason for deviation. In case of companies holding exclusive long term licenses to manufacture and sell in India, no such additions for AMP can be made based on international guidance on the matter and this should be clarified in Indian guidelines to be made.

Similarly guidelines should be laid down that the composite indivisible royalty can be tested for arms length under TNMM method at an entity level only as the type of technology and extent of technology imported by each company is different and CUP method cannot be applied. The import prices for components imported from AE to whom royalty is paid also varies from company to company depending on the technology and margins and that is another reason why CUP should not be applied to test arms length nature of royalty expense.

With an increase in the number of international transactions, the transfer pricing norms and the transfer pricing law are witnessing a rapid change. It is observed that the transfer pricing assessments are being used as the revenue generating scheme for the Government. For monitoring of the transfer pricing transactions the provisions U/s 92 to 92F have been enacted with a view to provide a framework which can lead to computation of reasonable, fair and equitable pricing which affects taxation in India. Thus any income/expenditure from international transaction has to be computed having regard to the Arms Length price (ALP).

There are various methods to settle down on ALP. But still transfer pricing is in its infancy and there are certain lacunas which need to be addressed. Some such points are given below :

Issue

4. One authority to decide the Arm's Length Price (ALP) for both Direct and Indirect Taxes (both of which comes under the Department of Revenue of Ministry of Finance)

Remark/suggestion

It is suggested that there should be a single authority to decide the ALP of a transaction so that the same price can be used for various judicial requirements. Customs and the Income Tax departments are having opposite ends to meet. While the Customs department doubts that the import price is 'undervalued', the Income Tax department doubts the same as 'overpriced'. Finally the assessee gets the hit from both the ends. Thus, may it be any arm of the Government, the price to be adopted should be the price determined by this single authority.

(a) Enough time for a proper assessment

The tax return for a given financial year is filed by December of the following assessment year, leaving 37 months to the TPO to do his assessment. But typically the assessments are conducted within the last 6 to 8 months, most of the time giving just few days (less than a week) to the assessee to respond to the queries / show cause notices.

(b) Interactive Dialog

The TPO should have a dialogue as to the method and comparables used in the TP review report, discuss mutually about the requirements to have a revised / altered / new study to arrive at proper comparables. This will avoid basic disputes, like captive unit compared with normal business units, comparison of controlled transactions, corporate guarantee / loan given to an AE compared with a banking company, etc.)

(c) No Cherry Picking

While finalizing ALP, the major drawback is that the loss making companies are not considered at all although it is normally settled that new companies, companies going through economic / product cycle etc. are loss making in their initial / interim phases.

Therefore, the companies chosen for the comparison should not be by cherry picking.

Issue

5. Determination of Comparable and choosing an appropriate method for determination of the ALP.

Explanation

The biggest hurdle in the provisions of transfer pricing laws is the determination of the proper comparables. Due to non-availability of data and comparables there is a a remote possibility of selecting a proper comparable. Depending on the comparable selected, finally depends the method of determination of ALP.

Remark

It is suggested that there should be concrete and specific directions to select the "Comparable" (which are not controlled ones and the adjustments that may be required based on the FAR analysis). Countries like USA, UK, Germany, France, Japan, Singapore and Netherlands have detailed guidelines, including that for intangibles. Further use of multiple year data should be permitted. Multiple year data captures market/business cycles and smoothen the effects of yearly aberrations, giving good results statistically. Lack of specific guidance on selection of comparable leads to wrong selection of ALP Method.

No clarity in benchmarking.

Since there is no specific provision to guide the benchmarking, this step becomes more critical. There should be specific provisions illustrating the proper and specific steps to taken in the benchmarking process. Even though there are provisions to adjust based on the FAR analysis, the same is not practiced during the assessments.

Giving greater authority and responsibility to the TPO

Giving greater authority under the TP assessment provisions and at the same time making the TPO responsible for frivolous adjustments is expected to yield more sincere and meaningful assessments.

Issue

6. Filing of tax return and transfer pricing report by foreign companies

Explanation

As per section 139(1)read with section 5 of Income Tax Act, every person (which includes foreign Company)having income accrued or received in India, has to File income tax return in India, even if does not have permanent establishment in India.

As per section 92D read with section 92E every person (which includes foreign company) who has entered into international transaction, shall maintain transfer pricing documents and shall file TP (transfer pricing) certificate with tax authorities.

The Indian Company is deducting TDS from taxable payments to Foreign Company and TDS return with all details is filed with tax authorities. Indian company is also filling TP certificate with all detail of transactions with Foreign Company with tax authorities.

Remark

It is inappropriate to burden foreign companies to file TP report and Income Tax return for similar transactions already reported by Indian Company and on which due tax has already been deducted by Indian Company. In other countries also it seems that foreign companies are exempted from such compliances

Industry is of the opinion that unless foreign company has a Permanent Establishment in India, in respect of incomes earned from India, the foreign company shall not be required to file TP report relating to Indian Transfer Pricing regulations and filing of tax return with tax authorities in India

Provisions can be made that foreign companies shall be exempted from filling income tax return and TP certificate with tax authorities.