



CBDT notifies the much awaited revised Safe Harbour Rules

Background

To curb the increasing number of transfer pricing audits and prolonged disputes, the Central Board of Direct Taxes (CBDT) issued the Safe Harbour Rules (SHRs) in September 2013¹. However, the safe harbour programme received a tepid response from taxpayers in India, due to perceived high margins and ambiguity in the classification of services. The CBDT has now, vide a notification² dated 7 June 2017, revised the existing safe harbour rules in India.

Applicability

The revised SHRs apply for Assessment Year (AY) 2017-18 and two immediately following AYs i.e. upto AY 2019-20. The earlier SHRs were applicable from AY 2013-14 and four immediately following AYs i.e. upto AY 2017-18. For AY 2017-18, the taxpayer can choose from old or new rules whichever are more beneficial.

Key highlights

- **Rationalisation of safe harbour rates:**

The safe harbour rates for all contract services have been moderated. The key changes are:

- The safe harbour rates for Information Technology (IT) and Information Technology enabled services (ITeS), earlier in the range of 20 - 22 per cent have been brought down to 17 -18 per cent.
- The safe harbour rates for Knowledge Process Outsourcing (KPO) services which earlier at 25 per cent have been brought down to 18 per cent, 21 per cent and 24 per cent depending upon the percentage of employee cost to operating cost.
- The safe harbour rate for contract Research and Development (R&D) service providers (for IT and generic pharmaceutical drugs) has been brought down from 29 – 30 per cent to 24 per cent.

- **Upper turnover threshold of INR200 crore introduced:**

This has been introduced for all contract service providers [IT, (ITeS), KPO, R&D for IT and generic pharmaceutical drugs]. For AY 2017-18, since the taxpayers have an option to choose from old or new rules, even the taxpayers with relevant international transactions of more than INR200 crore can opt for safe harbour as per the old rules.

- **Introduction of safe harbour for receipt of low value adding intra group services:**

Contrary to India's earlier stand on simplified mechanism for low value-adding intra-group services, the safe harbour provisions have been extended to receipt of such services by Indian entities under the revised SHRs.

¹ [KPMG Flash news dated 20 September 2013 - Transfer Pricing - Safe Harbour Rules – Notified](#)

² CBDT Notification No. 46/2017/ F. No. 370142/6/2017-TPL

Whilst the SHRs in this regard are largely in line with the guidelines issued by Organisation for Economic Co-operation and Development's (OECD) under Base Erosion and Profit Shifting (BEPS) Action Plans 8-10, in definition of low value-adding intra-group services, there are certain deviations. To be covered by SHRs, such services should:

- be in the nature of support services;
- not be a part of the core business of the multinational enterprise (MNE) group;
- not be in the nature of shareholder services or duplicate services;
- neither require the use of unique and valuable intangibles nor lead to the creation of unique and valuable intangibles;
- neither involve the assumption or control of significant risk by the service provider nor give rise to the creation of significant risk for the service provider; and
- should be services which do not have reliable external comparable services that can be used for determining their arm's length price (ALP).

There is a prescribed list of ten categories of services which have been specifically excluded from the ambit of low value-adding intra-group services. Services like in the nature of IT (software development), KPO, BPO services are amongst the excluded services.

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

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

In this regard, the definition of an accountant has also been incorporated in the revised SHRs.

- **Safe harbor rates for KPO services:**

For the application of staggered safe harbour rates for KPO services, which is dependent upon the application of employee cost to operating cost ratio, the term 'employee cost' has been comprehensively defined to include various items of employee compensation and benefits like salaries and wages, gratuities, perquisites, bonus or commission, lumpsum payments received on termination of service, expenses incurred on contractual employment of persons performing tasks similar to those performed by the regular employees, recruitment, relocation, training expenses etc.

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

- **Introduction of safe harbour rates on loans advanced in foreign currency:**

The revised SHRs have prescribed safe harbour rates based on London Inter-bank Offer Rate (LIBOR) for loans advanced to AEs denominated in foreign currency. The revised SHRs have also prescribed staggered rates (spread over the applicable base rates) depending upon the credit rating of the overseas borrower, subject to such credit ratings being approved by CRISIL. CRISIL (formerly Credit Rating Information Services of India Limited) is a global analytical company providing ratings, research, and risk and policy advisory services. CRISIL's majority shareholder is Standard & Poor's, a division of McGraw Hill Financial and provider of financial market intelligence.

- **Clarifications on definition of operating costs and operating revenue:**

The revised SHRs have amended the definition of operating expenses to include:

- Costs relating to Employee Stock Option Plan (ESOP) provided for by the AE

- Reimbursement to AE for expenses incurred by the AE on behalf of the taxpayer (subject to such reimbursements being at cost); and
- Amounts recovered from AE which relate to normal operations of the taxpayer (subject to such recoveries being at cost).

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

Safe harbour rates:

Categories of international transactions	Safe harbour rates - old rules [as per sub Rule (2) of rule 10TD of Income-tax Rules, 1962] applicable from AY 2013-14 to AY 2017-18	Safe Harbour rates - revised rules [as per sub Rule (2A) of rule 10TD] applicable from AY 2017-18 to AY 2019-20
Provision of Software development services (IT services) and Information Technology Enabled services (ITeS), with insignificant risks.	Operating profit margin to operating expense <ul style="list-style-type: none"> • where the aggregate value of such transactions \leq INR500 crore – not less than 20 per cent • where the aggregate value of such transactions $>$ INR500 crore – not less than 22 per cent. 	Operating profit margin to operating expense <ul style="list-style-type: none"> • where the aggregate value of such transactions \leq INR100 crore – not less than 17 per cent • where the aggregate value of such transactions $>$ INR100 crore but $<$ INR200 crore - not less than 18 per cent.
Provision of KPO services, with insignificant risks	Operating profit margin to operating expense not less than 25 per cent	The value of international transaction \leq INR200 crore and the operating profit margin to operating expense is – <ul style="list-style-type: none"> • Not less than 24 per cent, if the employee cost to operating expense is at least 60 per cent • Not less than 21 per cent, if the employee cost to operating expense is greater than 40 per cent or more but less than 60 per cent; or • Not less than 18 per cent, if the employee cost to operating expense does not exceed 40 per cent.

<p>Provision of Intra-group loan to Wholly Owned Subsidiary (WOS)</p>	<p>Interest rate equal to or greater than the base rate of State Bank of India (SBI) as on 30th June of the relevant previous year:</p> <ul style="list-style-type: none"> • plus 150 basis points where the amount of loan is \leq INR50 crore • plus 300 basis points where amount of loan is $>$ INR50 crore 	<p><u>The threshold of INR50 crore has been removed</u></p> <p>Different safe harbour rates have been prescribed for</p> <ul style="list-style-type: none"> • <u>Loan denominated in Indian Rupees (INR)</u> <p>Refer table 1 below</p> <ul style="list-style-type: none"> • <u>Loan denominated in foreign currency</u> <p>Refer table 1 below</p>
<p>Provision of Corporate guarantee to WOS</p>	<ul style="list-style-type: none"> • where the amount guaranteed \leq INR100 crore - Commission or fee of 2 per cent or more per annum • where the amount guaranteed $>$ INR100 crore, and the credit rating of the borrower, by a Securities and Exchange Board of India (SEBI) registered agency is of the adequate to highest safety - Commission or fee of 1.75 per cent or more per annum. 	<p>The differential rates of 2 per cent and 1.75 per cent have been moderated down to a standard rate of 1 per cent irrespective of the amount guaranteed.</p> <p>However the requirement for the credit rating of the borrower to be certified by a SEBI registered agency and such credit rating to be of adequate to highest safety still remains for amount guaranteed exceeding INR100 crore.</p>
<p>Provision of specified contract research and development services (Contract R&D services), with insignificant risks, wholly or partly relating to software development</p>	<p>Operating profit margin to operating expense not less than 30 per cent.</p>	<p>The operating profit margin to operating expense not less than 24 per cent, where the value of the international transaction is \leq INR200 crore.</p>
<p>Provision of contract R&D services, with insignificant risks, wholly or partly relating to generic pharmaceutical drugs</p>	<p>Operating profit margin to operating expense not less than 29 per cent.</p>	<p>The operating profit margin to operating expense not less than 24 per cent, where the value of the international transaction is \leq INR200 crore.</p>
<p>Manufacture and export of:</p> <ul style="list-style-type: none"> • core auto components • non-core auto components where 90 per cent or more of total turnover relates to Original Equipment Manufacturer sales. 	<p>Operating profit margin to operating expense:</p> <ul style="list-style-type: none"> • not less than 12 per cent • not less than 8.5 per cent 	<p>Operating profit margin to operating expense:</p> <ul style="list-style-type: none"> • not less than 12 per cent • not less than 8.5 per cent
<p>Receipt of low value-adding intra-group services.</p>		<p>Aggregate value of such transactions (including a mark-up not exceeding 5 per cent), does not exceed INR10 crore.</p> <p>Method of cost pooling, exclusion of shareholder costs and duplicate costs from cost pool and the reasonableness of the allocation keys used for allocation of costs to be certified by an</p>

		accountant.
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Table 1 – Safe harbour rates prescribed for loans advanced to AE

CRISIL credit rating of AE	Loan in INR - Interest rate \geq one-year marginal cost of funds lending rate of State Bank of India as on 1 April of the relevant previous year plus basis points as below:	Loan in Foreign currency - Interest rate \geq six-month London Inter-Bank Offer Rate of the relevant foreign currency as on 30 September of the relevant previous year plus basis points as below:
between AAA to A or its equivalent	175 basis points	150 basis points
BBB-, BBB or BBB+ or its equivalent	325 basis points	300 basis points
between BB to B or its equivalent	475 basis points	450 basis points
between C to D or its equivalent	625 basis points	600 basis points
Credit rating not available and aggregate amount of loan advanced to all AEs as on 31 March of the relevant previous year < INR100 crore.	425 basis points	400 basis points

Our comments

The SHR which were first released in 2013 did not attract much response from the taxpayers as the recommended rates were perceived to be very high. Thus, moderation of the SHR has been eagerly awaited by the Indian taxpayers.

Setting of an upper turnover threshold limit at INR200 crore for all contract service providers (IT, ITeS, KPO, R&D for IT and generic pharmaceutical drugs) is indicative of the CBDT's intention to restrict the applicability SHR to only small to medium sized entities. Further, moderation of safe harbour rates to relatively lower profit margins may see more taxpayers opting for SHR thereby avoiding long drawn litigation.

Larger players having international transactions of more than INR200 crore do not have the option of safe harbour starting AY 18 -19. Such taxpayers may either opt for an Advance Pricing Agreement (APA) or normal assessment route which may involve litigation. It is important to note that, the revised SHR are only applicable for three years compared to the certainty of five years offered by APAs (nine years, if rollback is sought).

Considering the Indian government's earlier stand to refrain from adopting OECD BEPS Action Plan 8-10 guidelines on low value-adding intra-group services, the extension of safe harbour on such services is a welcome step. Even though the definition of low value-adding intra-group services is largely in line with the OECD BEPS Action Plan 8-10 guidelines, the exclusion of BPO and KPO services from such services may limit the applicability of safe harbour in many cases.

Though the monetary threshold for applicability of SHR on receipt of low value adding intra-group services has been kept to a modest INR10 crore, the CBDT has certainly made a promising start to address the much-litigated issue pertaining to intra group services.

Including safe harbour norms for foreign currency outbound loans is another welcome step. Linking the interest rate with the credit rating of the borrower seems to be a rational approach, however, the obligation of having the credit rating approved by CRISIL may prove to be an onerous burden for taxpayers.

Overall, the revision of the safe harbour rates is indicative of a sincere intent of the Indian tax authorities to provide a non-adversarial tax regime.

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