BEYOND ARMS LENGTH PRICE: SAFE HARBOURS IN TRANSFER PRICING


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BACKGROUND

Global trade has significantly increased, creating an unprecedented level of integration in recent years. Globalisation and the rapid growth of international trade have resulted in increased play of cross border related party transactions. Since the launch of the BEPS project by the OECD, transfer pricing has become one of the most important part of board room discussions. In the recent times, the COVID-19 pandemic has given rise to unprecedented uncertainties, which has posed challenges to the conventional principle of arms length price. Absence of precedence, lack of comparable data, changing risk landscape, newer business models, difficulty in determining transfer pricing adjustments are only some of the several challenges faced while determining arms length price. On the other hand, tax administrations across the globe are focused on augmenting tax collections to fund deficits caused by the stimulus packages.

Gaining certainty in tax outcomes on account of transfer pricing, has thus become one of the most important areas of focus for MNEs. Traditionally, safe harbours have been considered to be one of the most cost effective mechanism to gain transfer pricing certainty. Safe harbours, have always been considered an effective tool to it could condense potential tax litigation for eligible taxpayers and also facilitate tax administrations to extend their resources for more convoluted and risky transactions.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 ('OECD guidelines') have noted the following:

"4.101 Some of the difficulties that arise in applying the arm's length principle may be avoided by providing circumstances in which eligible taxpayers may elect to follow a simple set of prescribed transfer pricing rules in connection with clearly and carefully defined transactions, or may be exempted from the application of the general transfer pricing rules. In the former case, prices established under such rules would be automatically accepted by the tax administrations that have expressly adopted such rules. These elective provisions are often referred to as 'safe harbours'."

Safe harbours are legal provisions which **provide immunity** or **sidestep regulatory liability** for a defined category of taxpayers or transactions provided certain conditions are met.

TYPES OF SAFE HARBOURS

A transfer pricing safe harbour **substitutes simpler obligations** in place of those prescribed under general transfer pricing regime. Often, eligible taxpayers complying with the transfer pricing safe harbour provision are **relieved from compliance obligations and/or documentation requirements**. Several countries across the globe, have incorporated safe harbours as part of their local tax and transfer pricing laws. Transfer pricing safe harbours are majorly of **four different types**:

1. Safe harbours providing **exemption from transfer pricing regulations** or **relief from transfer pricing compliance**

2. Safe harbours for applying **simplified transfer pricing method**

3. Safe harbours in form of **arm's length rates/tolerance ranges** for specific transactions

4. Safe harbour **Interest rates** (in some cases, are a part of '**thin capitalisation**' regulations)

Access to safe harbours may be conditional and subject to:

- Category of taxpayers
- Type of transactions
- Quantitative thresholds
- Profit, Interest rate or price range
- Circumstantial/situational trigger

While most safe harbours are unilateral simplification measures implemented by tax administrations, countries may also agree on a bilateral or multilateral safe harbours. Pertinence of safe harbour can be expected to be most evident when it is **directed at a taxpayer** and/or a **transaction that entails low transfer pricing risk** and is adopted on a **bilateral or a multilateral** basis.

ENIGMAS OF SAFE HARBOUR

While safe harbour regimes do have advantages, they also give rise to some challenges.

- Safe harbours may increase the **risk of double taxation or double non-taxation** when implemented unilaterally. E.g. MNE group entity in Country A earns income on a cost plus mark up basis from related party in Country B and such entity in Country A opts for a prescribed safe harbour at cost plus 18%. Country B does not acknowledge such safe harbour and prescribes application of arm's length principles for such payment, resulting in arms length price of cost plus 15%. In such a case the differential markup may result into a transfer pricing adjustment of 3% (on cost) in the hands of the related party in country B; which may thus resultin the double taxation of the same 3% (on cost).

- Safe harbours may potentially open boulevards for inapt **tax planning**. Groups may enter into artificial arrangements for the purpose of exploiting safe harbour provisions. E.g., In order to access safe harbours in case of a simple transaction, a group may dissect the transaction in smaller parts to make them seem simple.

- Safe harbours may also boost issues around parity and homogeneity. Preferential tax treatment under safe harbour regimes for aspecific category of taxpayers could potentially lead to disparity and entail competitive disruptions.

Safe harbours do not bind or limit in any way any tax administration other than the tax administration that has explicitly embraced the safe harbour leading to above mentioned challenges. Thus, safe harbour rules may raise underlying problems that could potentially have negative effect on the pricing decisions of entities party to controlled transactions. Thus, principally, safe harbours may not be compatible with the arm's length principle of transfer pricing.

SAFE HARBOURS IN INDIA: AN OVERVIEW

As stated above, safe harbour regime aims at increasing the efficacy of transfer pricing analysis by providing specific pricing mechanisms and thereby reducing the compliance cost for the taxpayer and providing tax certainty. It also facilitates in reducing administrative burden of the tax authorities. Considering such benefits, safe harbour provisions were introduced in India vide the Finance Act, 2009.

Section 92CB of the Income-tax Act, 1961 ('IT Act') provides the power to the CBDT to notify the safe harbour rules. Further, Rule 10TA to Rule 10THD of the Income-tax Rules, 1962 encompasses the relevant rules in this regard.

The safe harbour rules were first notified in September 2013 and were applicable for AY 2013-14 onwards. The Central Board of Direct Taxes ('CBDT'), vide a notification dated 7 June 2017, revised the then existing safe harbour rules in India for a three year period beginning AY 2017-18 to AY 2019-20.The revised rules provided taxpayers with an option to choose from erstwhile or revised rules, whichever taxpayer considered more beneficial. Further, the CBDT by way of notification dated 20 May 2020 and 24 September 2021, extended provisions of revised safe harbour rules to AY 2020-21 and AY 2021-22 respectively.

The eligible international transactions notified so far based on the revised safe harbour rules have been tabulated below for a quick reference:

Sr	Nature of International Transaction[1]	Safe Harbour (Appliable from AY 2017-18 to AY 2020-21)
1	Provision of software development services or information technology enabled services	Threshold: Transactions up to INR 100 crores Operating Profit ('OP')/Operating Expenses ('OE') >=17%
		Threshold: Transactions up to INR 200 crores OP/OE >= 18%
2	Provision of knowledge process outsourcing services	Threshold: Transactions up to INR 200 crores 1. OP/ OE >= 24% and Employee Cost ('EC')/OE >=60% 2. OP/ OE >= 21% and EC/OE >=40% and <=60% 3. OP/ OE >= 18% and EC/OE <=40%
3	Advancing of intra-group loans in INR	Threshold: Transactions upto INR 100 crores One-year SBI MCLR as on April 1 plus 175 to 625 basis points, depending on the credit rating of the associated enterprise[2]
4	Advancing of intra-group loans in foreign currency	Threshold: Transactions upto INR 100 crores Six-month LIBOR of the relevant foreign currency as on 30th September plus 150 to 600 basis points depending on the credit rating of the associated enterprise[2]
5	Providing corporate guarantee	Commission >= 1% p.a. of the amount guaranteed.
6	Provision of contract research and development services wholly or partly relating to 1) software development or 2) generic pharmaceutical drugs	Threshold: Transactions upto INR 200 crores OP/OE>=24%
7	Manufacture and export of auto components	Core: OP/OE >=12% Non- Core: OP/OE>=8.5%
8	Receipt of low value-adding intra-group services	Threshold: Transactions upto INR 10 crores Markup<=5%[2]

[1]For Safe Harbours around Specified Domestic Transactions kindly refer to the Rule 10THC of the Income Tax Rules, 1962
[2]Please refer Rule 10TD (2A) of the Income Tax Rules, 1962 for exact law

In addition to the above, in order to provide tax certainty to the Indian taxpayers and amplify the array of safe harbours, vide Finance Act 2020, specific provision were introduced under the IT Act with respect to bringing attribution of profits to a permanent establishment within the ambit of safe harbour and APA regimes. Specific guidance in relation to such safe harbours is still awaited.

The Indian tax administration has also incorporated thin capitalization regime in the Indian IT Act vide section 94B. These have been introduced with a specific intent to curb thin capitalisation in India. These could be considered as a form of safe harbour which puts a cap on excessive interest payments being made beyond a stipulated threshold. The introduction is the said safe harbour is in line with the recommendations by the OECD base erosion and profit shifting (BEPS) project.

SAFE HARBOURS IN INDIA: PROCEDURE AND RELATED SUBTLETIES

Indian Transfer Pricing Regulations provide for the procedure to apply for safe harbours under Rule 10TE and Rule 10THD of the Income-tax Rules, 1962. As prescribed in the said Rules, a taxpayer would have to file an application with the (Form No 3CEFA for International Transactions and Form 3CEFB for Specified Domestic Transactions) assessing officer on or before due date of furnishing the return of income to opt for the said regime. Further, in case of international transactions a taxpayer can opt safe harbours for a single year or multiple years based on his choice. In case of a multi-year application, taxpayer can opt out of the safe harbour regime from the second year onwards, by filing a declaration, if required.

It is worthwhile to note that if an application is filed by the taxpayer opting for the safe harbour and order invalidating the same is not passed by the tax authority within stipulated time-frame, then it would be deemed valid exercise of safe harbour option in such a case. In case the taxpayer fails to furnish the statement to assessing officer from the second year onwards providing information such as eligible transactions, their quantum, profit margins etc. before furnishing the return of income of that year, then in such case the safe harbour would be deemed to have not been exercised validly.

Further, it is also important to note that, Rule 10TA (i.e., safe harbour regime) of the Income-tax Rules, 1962 and Rule 10B of the Income-tax Rules, 1962 are mutually exclusive when it comes to determination of arm's length price. This would mean that the definitions provided in Rule 10TA (for instance operating revenue, operating expense) would not apply in case of determination of arm's length price as per Rule 10B. E.g., A taxpayer may consider foreign exchange fluctuations as operating for the purpose of Rule 10B but, for the purpose of safe harbours such fluctuations will have to be treated as non-operating.

SAFE HARBOURS IN INDIA: AN EVALUATION

Existing safe harbour mechanism in India has failed to cut the mustard as an alternate dispute resolution mechanism. Safe harbour mechanism, compared to other available dispute resolution mechanisms, has showcased a bleak growth. This is evident as the Indian taxpayers have maintained a safe distance from the safe harbours over the years.

Some of the reasons for taxpayer's reluctance to opt for the Indian safe harbour regime have been evaluated below:

- There are number of dispute resolution mechanisms available for a taxpayer in India, which although time consuming but generally yield desired outcome for the taxpayer. Further, the price / margin to be offered under the Indian safe harbours are perceived to be on a higher side compared to the benchmarks and outcome obtained via other dispute resolution mechanisms.

- Safe harbours in India are unilateral leading to a negative impact. E.g., the Indian safe harbour requires a taxpayer to earn a margin of 17% - 18% from provision of software development services. Such an expectation may not be in the interest of the MNE as a whole nor practically acceptable to other jurisdictions of the MNE. This may also lead to the issue of double taxation.
- Rather than simplifying and easing the compliance requirement, the taxpayer is still required to maintain the transfer pricing documentation and furnish report in form 3CEB.
- Rulings by Honourable Tribunal wherein safe harbours relied upon by the TPO without performing any benchmarking have been rejected and lower margin of taxpayer is accepted. Thus, margins lower than those prescribed by the safe harbours are well accepted making safe harbour route less lucrative.
- Under the Indian safe harbour regime forex fluctuations are considered as non-operating activity and thus gain/losses are excluded while calculating margins. This may be so despite such forex fluctuations being related to the core operations of the taxpayer and a revenue expenditure.
- The definition of 'Low Value Added Intra-group Services' in Rule 10TA of the Income Tax Rules, 1962, specifically excludes business process outsourcing services which includes low end services such as accounting, HR and such related support services. Such an exclusion has not been provided in the OECD guidelines. This has restricted the applicability and confused the Indian taxpayer as to what services can really be construed as Low Value Added Intra-group Services.
- Para 4.117 of the OECD Guidelines, explicitly states the below:

  "… the country adopting the safe harbour should generally be prepared to consider modification of the safe-harbour outcome in individual cases under mutual agreement procedures to mitigate the risk of double taxation."

  However, Rule 10TG of the Income-tax Rules, 1962 contrarily states the following:

  "Rule 10TG. Where transfer price in relation to an eligible international transaction declared by an eligible assessee is accepted by the income-tax authorities under section 92CB, the assessee shall not be entitled to invoke mutual agreement procedure under an agreement for avoidance of double taxation entered into with a country or specified territory outside India as referred to in section 90 or 90A."

  Today, when no MNE operates on a sequestered basis, a compelling argument may be drawn against existing safe harbour mechanism.

SAFE HARBOURS IN INDIA: KEY EXPECTATIONS OF TAXPAYERS

- Rationalised safe harbour rates/margins aligned to economic reality and global expectations, especially given the disruption caused by the COVID-19 pandemic.
- Where a taxpayer has opted for a safe harbour mechanism, in order to reduce the compliance burden, statutory requirements of section 92D and section 92E of the IT Act ought to be eased out or done away with.
- The interest rates on loan, guarantee commission rate and markup for services covered under the safe harbour rules be determined based on actual market conditions and the economic outlook for the impact of COVID-19.

- Clarity and guidance could be provided about whether the incremental/unabsorbed costs incurred by the captives due to COVID-19 could be treated as extraordinary costs, thereby excluding the same while computing remuneration under cost-plus mark-up. The definition of Operating expenses provided in the Rule 10TA of the Income Tax Rules, 1962 may be appropriately altered.
- For the fiscal years impacted by COVID-19, the turnover threshold for transactions could be removed to help a greater number of taxpayers become eligible for safe harbours.
- Safe harbours for more activities like contract manufacturing, limited risk distribution, procurement support, marketing and sales support, business support, non-binding investment advisory services, management services, etc.

GLIMPSES OF SAFE HARBOURS ACROSS THE WORLD

Numerous countries across the world have implemented safe harbour provisions in their respective local tax laws. Such provisions or simplification measures in quintessence follow the ideology of safe harbour as described in OECD guidelines i.e., striking a balance between protecting the tax base and restricting the compliance costs.

Tabulated below are the key safe harbours that are currently operational in a few countries:

Country	Nature of transaction / taxpayer / arrangement	Prevailing safe harbour
New Zealand[3]	Low Value Adding Intra Group Services	▪ Cost plus 5% (no benchmarking required)
	Intra-Group Loans	▪ Threshold <= NZD10 million ▪ Rate of interest 3.75% over base indicator
	Foreign Owned Wholesale Distributors	▪ Threshold <= NZD 30 million ▪ Weighted average EBITE >= 3%
Australia[4]	Small Taxpayers or Distributors	▪ Threshold <= AUD 50 million ▪ If classified as a small taxpayer or distributor (specified conditions and thresholds), tax administration would not allocate resources to review the covered transactions.
	Low Value Adding Intra Group Services	▪ Threshold <= AUD 2 million considered immaterial (the *de minimis* rule) ▪ Threshold >= AUD 2 million ▪ Services rendered >= cost plus 5% ▪ Services availed <= cost plus 5%
	Low-Level Inbound Loans	▪ Threshold <= AUD 50 million ▪ Rate of interest <= 1.79% for 2021
	Low-Level Outbound Loans	▪ Threshold <= AUD 50 million ▪ Rate of interest >= 1.79% for 2021
	Materiality	▪ Total international related-party dealings<= 2.5% of total turnover for the group (and other conditions)
	Technical Services	▪ Threshold: Income and /or expenditure from technical services <= 50% of the total international related party dealings ▪ Services rendered >= cost plus 10% ▪ Services availed <= cost plus 10%
Italy	Low Value Adding Intra Group Services	▪ Cost plus 5%

[3]https://www.ird.govt.nz/international-tax/business/transfer-pricing/simplification-measures
[4]https://www.ato.gov.au/law/view/document?DocID=COG/PCG20172/NAT/ATO/00001&PiT=99991231235958

Country	Nature of transaction / taxpayer / arrangement	Prevailing safe harbour
Netherlands[5]	Low Value Adding Intra Group Services	▪ Cost plus 5% markup
	Thin Capitalization	▪ Anti-abuse rules might apply to limit the deduction of interest. These anti-abuse rules vary from the 30% EBITDA rule to limitations on interest deductions on
Czech Republic[6]	Low Value Adding Intra Group Services	▪ Cost plus 3% - 7%
Chile	Royalty	▪ Royalty Rate <=4%
Israel[7]	Low Value Adding Intra Group Services	▪ Cost plus 5% markup
	Limited Risk Marketing Services	▪ Cost plus 10%-12% markup
	Limited Risk Distributor	▪ 3%-4% operating margin
China[8] Argentina[9]	No prescribed safe harbours (even for Low Value Adding Intra Group Services need to be supported by an economic analysis from transfer pricing perspective)	

SAFE HARBOUR SPILLING OVER GLOBE PROPOSAL

Recently, in October 2020, the OECD released blueprints of Unified two Pillar 1 approach to Taxation of the Digital Economy. Simply put, Pillar 1 tries to address the concern about MNEs not paying fair taxes in countries where they have market facing activities. Against the said Pillar 1, which would be applicable to MNEs based on certain thresholds, USA has recently made a representation for an elective safe harbour regime i.e., giving the taxpayer an option to opt out of Pillar 1. The disadvantage of such an elective regime is that it is less likely to stop the proliferation of unilateral measures, as each MNE will have an option to opt in or out of the Pillar 1. Accordingly, at present ambiguity looms globally as to whether Pillar 1 be considered as a safe harbour or that it be applied to all the MNEs globally, uniformly, subject to certain thresholds. Such an elephant in the room definitely needs to be addressed, a fruitful solution and consensus as to the same among the global tax community.

[5]https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-netherlands.pdf
[6]https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-czech-republic.pdf
[7]https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-israel.pdf
[8]https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-china.pdf
[9]https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-argentina.pdf

As per the current working mechanism in Pillar 1 to ensure that jurisdictions where marketing takes place are remunerated fairly, some smaller groups could be left out due to applicable thresholds. In such a scenario, in case, suggestion of USA is accepted to provide the taxpayer (currently automatically not subject to Pillar 1 due to applicable thresholds) an option to opt for Pillar 1 by considering the same as a safe harbour, it may be considered to be an important suggestion toward the uniform policy development.

CLOSING REMARKS

While entering into any new arrangement, it is crucial for any MNE to give due regard to other tax jurisdiction's country-specific Regulations, Safe harbour rules, Withholding taxes, GST, Customs and other such regulations, etc. in conjunction with the overall economic situation of the MNE group, so as to bring out a tax effective arrangement.

It is without any element of doubt that safe harbour regime could act as an efficacious dispute resolution mechanism. A dynamic safe harbour regime with a scope that can accommodate the tumult as well as integrate the economic veracities of any MNE would make it a very taxpayer friendly tax regime. With the uncertainties posed by the COVID-19 pandemic, taxpayers world over would be keen evaluate relief under reasonable and fair safe harbour regimes which would allow them to focus their energies and resources in reviving and stabilising businesses.

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