# Rangachary Committee and Reflections on Safe Harbour Norms

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In the wake of widespread criticism of Revenue's high handedness on Transfer Pricing of IT sector, the 'Rangachary Committee' was constituted in July this year to review taxation of IT sector and suggest corrective measures for easing tax/ compliance burden on IT taxpayers.

It is learnt that the Committee has recently submitted its report to the Prime Minister. Though, the report is undisclosed, sources privy to the development have said that a final view shall be taken after seeking comments from stakeholders on committee's recommendations on safe-harbour norms and the approach to taxation of IT sector. The Committee is expected to finalize the safe-harbour rules by December 31, 2012.

In the backdrop of the proposed introduction of safe harbour norms this article looks at the OECD view on safe harbours, their pros and cons and some pertinent questions surrounding their application and enforcement.

**Concept of 'Safe Harbour'**

A 'safe harbour' can be any statutory provision or regulatory approach directed at simplifying transfer pricing compliance. The OECD lists two kinds of 'safe harbours':

- The first kind allows certain transactions to be completely excluded from the scope of transfer pricing provisions. Hence, the safe harbour provision demands no Transfer Pricing compliance of the taxpayer to the extent a transaction falls in the excluded category.
- The second kind allows simplification of rules applied to certain categories of taxpayers. Usually, subject to satisfaction of certain profitability thresholds, taxpayers may have no or significantly reduced documentation/ compliance burden with limited audit or scrutiny.

**OECD View – a welcome 'volte-face'**

Until recently, OECD had expressed reservations on extensive use of safe harbour provisions disapproving their use. The chief concern was the purported incompatibility of safe harbours based transfer prices with the arm's length principle.  Safe harbours permit a sweeping formulary approach which is in stark contrast with the arm's length principle requiring the price to be determined based on the facts and circumstances of each case.

However, with the release of a Discussion Draft on Safe Harbour Rules and the eventual Revision of OECD Transfer Pricing Guidelines, the OECD is poised to reverse course and endorse the use of safe harbour rules in appropriate situations. The sudden change in outlook is not surprising and stems from the escalation of transfer pricing documentation and planning burden globally that has reached unmanageable proportions.

**Safe Harbour Benefits**

*Compliance Relief*

Properly defined safe harbours may significantly ease compliance burden by eliminating data collection and associated documentation requirements in exchange for the taxpayer meeting specified pricing targets stipulated under safe harbour provisions.

*Certainty*

Qualifying taxpayers would be assured that they will not be subject to detailed audit or reassessment provided they have met pricing targets after meeting the eligibility conditions of safe harbour provisions.

*Administrative Simplicity*

Further, once eligibility of taxpayer for safe harbour has been established, the transfer prices would require minimal examination which shall go a long way in relieving tax authorities from heavy administrative burden cast by transfer pricing provisions.

**Concerns**

*Risk of Double Taxation*

As safe harbours may cause taxpayers to report income above arm's length level, this may lead double taxation should the overseas jurisdiction not concur with such reported income levels. Interestingly, OECD recommends adoption of 'bilateral safe harbours' agreed by both trading nations to eliminate double taxation.

*Possibility of opening avenues for tax avoidance*

Since safe harbours are usually applicable to 'small or simple' transactions, enterprises may be tempted to break transactions into small parts to make them seem small to avail safe harbours.

**Need for Safe Harbour Rules in India**

*Safe harbour Rules for Development Centres*

The safe harbour norms have particular relevance for several 'Development Centres' in India carrying out activities such as product development, analytical work, contract software development and R&D solely for the parent/ multinational group entities. Since the introduction of comprehensive Transfer Pricing regulations in India, captives have been the hotbed for controversy. Revenue Authorities have insisted on higher mark-ups in the range of 25-30 percent depending upon the nature of economic activity. It is reported that based on recommendations of the Committee, there may be a softening of stand on part of the Revenue and safe harbours at lower profitability threshold (14-18%) may be prescribed *[Source: Financial Express, October 7, 2012].*

*Should there be Safe Harbour Rules for Guarantee Transactions?*

Given the complete absence of safe harbours for even the simplest of transactions, safe harbours for guarantee may seem like a long shot. However, given the dramatic change in Indian Transfer Pricing landscape post Finance Act, 2012 this may be another area worthy of discussion. The Finance Act, 2012 has buried any doubts whatsoever on eligibility of guarantee as an international transaction requiring Transfer Pricing benchmarking and compliance like any other international transaction. However, not just in India but internationally, 'guarantee' transactions are the hardest to benchmark with limited alternative approaches available to address the issue. Infact, taking cognizance of the formidable data limitations afflicting guarantee benchmarking exercise, the American Bar Association recently recommended introduction of safe harbour rules for such transactions[1].

Given the complexity involved in a guarantee benchmarking exercise stipulation of safe harbours seems desirable even if the scope is limited to low value transactions.

**Concluding Remarks**

*Questions for Corporates*

In conjunction with the Advance Pricing Agreement mechanism, the safe harbour rules are set to reduce litigation providing a concrete planning basis for Transfer Pricing of international transactions. However, the existence of alternate dispute pre-emptive mechanisms poses the following interesting questions:

(i) Evaluation of APA versus safe harbour rules keeping in view the cost and time involved in each pre-emptive measure;

(ii) In the above context, whether the extent of cost plus mark-up and choice of comparables would be the appropriate subject matter of APAs?

(iii) Identification of other fundamental Transfer Pricing issues, for example, the characterization question – are Indian operations indeed auxiliary in value chain? What is the relative contribution of Indian operations vis-a-vis the supply chain? Is there deployment of significant intangibles by the development centre? Is the cost plus
mark-up a sufficient reward for development centre's value addition?

As the industry expectantly looks forward to safe harbour rules, a moot question is the eligibility criteria for safe harbour benefits. Normally such norms cover only low end or back office activity as it is easiest to determine profitability thresholds for such kind of activity. Hence, in this context, a critical question shall be the definition and scope of back office or 'development centre' activity. Amongst others, hopefully, the committee recommendations shall also squarely address this issue as the nation embarks on yet another year of Transfer Pricing planning and compliance.

*The Article has been authored by Ashutosh Mohan Rastogi (Partner, Amicus – Advocates & Solicitors) and Philip Mathew (Associate, Amicus) - Views expressed are personal*

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[1] Comments and Recommendations for Guidance to the Transfer Pricing of Related Party Guarantees – American Bar Association