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Chairman Speaks

As we come closer to the start of a new financial year one hopes to leave the past behind and see a new horizon of greater certainty & clarity - which by itself could contribute significantly in bringing back business confidence & help revive investments.

One still awaits much needed clarifications in regard to some of the provisions like those relating to Indirect Transfer of shares - which in absence of complete clarity continues to impede free flow of business & transactions.

Given the upcoming elections we have, as expected, had merely a Vote on Account this year which consequently has meant lack of certainty as regard what the law will be effective 1 April 2014 - and one will have to wait till June or July to the see the provisions of the full Budget. In fact there are several existing provisions which have a sunset clause and it remains to be seen whether they are extended beyond 31 March 2014 - as for instance the concessional tax rate applicable to dividends received from overseas companies and the corresponding relief available in regard to Dividend Distribution Tax in such cases.

While the hope of "conciliation" becoming an all new avenue available for dispute resolution will it seems have to wait for another day & opportunity, it seems ever more likely that one may soon see a new first in the form of an international arbitration of a tax dispute under a Bilateral Investment Protection Agreement.

It was indeed heartening to see the restoration of the earlier position enabling a taxpayer to go before the Authority for Advance Ruling, even where a Return of Income has been filed. In the meantime in the global arena work on the BEPS (Base Erosion & Profit Shifting) continues to progress rapidly.

While preparations for the 2014 Mumbai Congress are on in right earnest, please do come forward with any suggestions or inputs which you may have.

Editor Speaks

Happy New Year 2014 to the readers though late! This is the first issue of the IFA News Letter in year 2014.

India is the most happening place, both politically and professionally. The Central Board of Direct Taxes (CBDT) has notified the guidelines for application of General Anti Avoidance Rules (GAAR) with exemption/s and savings, though applicable from 1st April 2016 has left out certain income arising from transfer after 30th August 2010. The forms for advance ruling of GAAR have been notified with the procedure in place. Cyprus becomes notified jurisdiction with specified consequences.

The Judiciary goes far to decide on Charter party documents of ships and the Double Taxation Avoidance Agreements (DTAA). The taxability of interest on tax refunds, royalties, technical services is decided based on the DTAAs concerned.

Heartening it is to see the decision of the Supreme Court in Phillipines that gives importance to the spirit of the DTAA above the local laws, the decision of the Supreme Court of Spain based on the Laws of European Union (EU) as an experiment towards the entire world being one single Country. Other important issue is Court abroad has expanded Capital gains tax to real estate in the home country in indirect transfer by entities out of the country.

Sincere appeal to the readers to contribute and support the task of Organisation for Economic Co-operation and Development (OECD) for the next update to the Model Tax Convention and the comments on proposed changes in the Article dealing with income from ships and air-crafts.

Inside this Issue

Courts Speak

I. Indian Rulings

Pratikshit Misra
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1. *Verizon Communications Singapore Pte Ltd v. ITO* [1]

Income from International Private Lease Circuit ('IPLC') is taxable in India as royalty.

The taxpayer was engaged in the business of providing international connectivity services. IPLC is an end to end managed dedicated bandwidth service that provides internet service to customers for various applications. A customer taking a lease connection between its Indian and overseas office enters into an arrangement with the taxpayer for the provision of international connectivity in the overseas leg and with VSNL for Indian half of the connectivity. The gateway/the landing station in India used in transmitting the traffic within India belonged to VSNL

The tax authorities and appellate authorities held that the income received by the taxpayer was taxable in India as 'royalties' under the Indian tax laws and India-Singapore DTAA.

On appeal before the High Court, the taxpayer *inter alia* contended that (i) it was rendering services to customers; (ii) the customers did not control the equipment/network used for rendering the service; (iii) no part of the international network was exclusive for any Indian customer; and (iv) network equipment remained under the possession, control, operation and use of the assessee and VSNL respectively.

Ruling against the taxpayer, the High Court analysed the agreements of the taxpayer and various earlier tax rulings before *inter alia* holding that (i) the taxpayer has primarily argued on the grounds that there was no use of any equipment and that there was rendering of service only; (ii) the arrangement with VSNL has to be necessarily integrated having regard to the close functional relationship with the taxpayer; (iii) the taxpayer has not rendered a service but in fact earned revenues from the customers for use / right to use of its equipment; and (iv) alternatively, the use of the process was provided by the taxpayer for which it earned the revenues.

2. *Marine Links Shipping Agencies v. CIT* [2]

Based on the terms of the charter party agreement and the manner of computing the amount payable to the owner of the ship, the owner and not the charterer was considered as the freight beneficiary.

As per terms of the charter party agreement between the Charterer (Netherlands tax resident) and the Ship Owner (Iranain tax resident), the Charterer was required to pay 100% freight charges minus 3.75% commission to the Owner. The Charterer was entitled to 2.50% of the commission (out of total 3.75% commission mentioned above). There was a minimum freight payable by the Charterer to the Owner to the extent of 19,500 tonnes. If the cargo exceeded 19,500 tonnes, the Owner was entitled to additional freight.

The Chartered claimed that it is the beneficiary of the freight income and invoked the provisions of the India-Netherlands tax treaty for non taxability in India. The tax authorities contended that the Owner was the beneficiary of the freight income and denied benefits of the India-Netherlands tax treaty.

On further appeal and on facts, the High Court held that the Owner was the substantial freight beneficiary and not the Charterer. Further, on reading the clauses of the charter party agreement, the High Court concluded that the Charterer was in fact more in the nature of an agent of the Owner and not a charterer. Accordingly the benefits of the India-Netherlands tax treaty were denied.

3. *Novo Nordisk India Pvt Ltd v. DCIT* [3]

ESOP recharge cost paid by Indian subsidiary to foreign parent company is tax deductible revenue expenditure for the Indian subsidiary

Under the ESOP policy formulated by the Indian Company and as per the guidelines of the global ESOP policy, the employees of the Indian Company were entitled to purchase shares of the Parent Company of the Indian Company at a discounted price (subject to a lock in of 3 years). The Parent Company's shares were listed on the Danish Stock exchange. The difference between the purchase price of the shares and the average market price of the shares during the purchase offer period ('ESOP recharge cost') was recharged by the Parent Company to the Indian Company. Such ESOP recharge cost was claimed as tax deductible expenditure by the Indian Company.

The Assessing Officer ('AO') denied the deduction of ESOP recharge cost on the grounds that (i) because of the lock-in period, it was a capital expenditure; (ii) the expenditure resulted in capital building of the Parent Company; (iii) no expenditure incurred by the Indian Company in the regular course of its business; (iv) the shares were listed on Danish stock exchange and therefore SEBI guidelines would not apply. The Commissioner of Income Tax (Appeals) [CIT(A)] upheld the order of the AO further observing that a capital expenditure of the Parent Company is being cloaked in the garb of the revenue expense claim of the Indian Company.

On further appeal, the Tribunal allowed the ESOP recharge cost as tax deductible expenditure on the grounds that (i) the cost was not a capital expenditure of the Parent Company; (ii) it was an employee cost for the Indian Company which is a revenue expenditure incurred for the purpose of its business; (iii) the

[1] TS-577-HC-2013(MAD)
[2] TS-497-HC-2013(KAR)
[3] TS-524-ITAT-2013(Bang)

expenditure is necessary for the Indian Company to retain a health work force; and (iv) the immediate beneficiary is the Indian Company though the parent company may also be an indirect beneficiary.

4. Metro & Metro v. ACIT [4]

Leather testing charges paid by a 100% exporter to a German company for services rendered in Germany would be taxable in India as fees for technical services. However, no disallowance under section 40(a)(i) is warranted on account of retrospective amendment to section 9.

The taxpayer was a manufacturer and exporter of leather goods. The taxpayer remitted fees to a Germany based company in respect of leather testing charges, but did not withhold the applicable taxes from these remittances. The testing services did not benefit the taxpayer in any other way except for compliance with statutory requirements in Germany with regard to the safety of products.

The AO disallowed the deduction of such expenditure on account of failure of the taxpayer to withhold taxes on the said remittances. The CIT(A) upheld the order of the AO.

On second appeal, the Taxpayer raised alternative arguments to contend that (i) the testing charges were not taxable in India; and (ii) no disallowance under section 40(a)(i) is warranted on account of retrospective amendment to section 9.

On facts, the Tribunal held that the testing charges constituted fees for technical services and were taxable in India. The key observation of the Tribunal in this regard were (i) the source rule would mean that irrespective of the situs of services, the situs of taxpayer and the situs of utilization of services will determine the tax jurisdiction; (ii) when no human intervention is involved in any services, such services cannot be treated to be of the nature which can be covered by section 9(1)(vii); (iii) a business is set up and carried on India irrespective of where the end consumers are.

However, the Tribunal held that no disallowance was warranted under section 40(a)(i) if the amount paid was not taxable in India in the light of the legal position as it prevailed at that point of time, and it became taxable in India only as a result of a retrospective amendment.

5. Marriott International Licensing Co BV v. DDIT [5]

Receipts towards creation and not use of a brand cannot be characterized as royalties.

The taxpayer had entered into an International Sales and Marketing Agreement ('ISMA') with an Indian hotel company. The taxpayer collected sales and marketing contribution from various hotels in accordance with the terms of the agreements with the hotels. The contribution would go to a centralized marketing fund which was operated on a cost basis, without any profit or mark-up. The amounts collected were spent on advertising, sales and marketing activities. The taxpayer contended that the receipts under ISMA were not taxable in India.

The AO held that the receipts of the taxpayer under ISMA were in the nature of royalties and were taxable in India.

On second appeal, the Tribunal relied upon its earlier ruling to hold that the contribution received by the taxpayer was towards activities for creation / swelling of a brand and not for 'use of a brand'. Hence, the contribution would not constitute royalties in the hands of the taxpayer.

6. Endemol India Pvt Ltd[6]

Line production services rendered by a non-resident cannot be considered as Fees for Technical Services

The applicant had engaged an entity in Argentina for providing line production services in Argentina. The question before the AAR was whether the payments for such line services would constitute fees for technical services.

The AAR upheld the contention of the applicant that the services under question would be considered as 'works' under section 194C and accordingly would not be considered as fees for technical services under section 194J in the context of payments to Indian residents. Applying the same rationale, the services would not constitute fees for technical services under section 9(1)(vii) either. Accordingly, the said payment would not taxable in India unless there is a business connection in India under section 9(1)(i).

7. Mitsubishi Corporation[7]

Mere filing of tax return does not bar the filing of application before the AAR

The applicant filed its tax return on 30th November 2011. It filed an application before the AAR on 4th April 2012, ie after filing the tax return. The notice under section 143(2) was issued on 8th August 2012, ie after the date of the application.

The tax authorities objected to the admissibility of the application stating that return of income was filed before filing the application and relied upon earlier rulings of the AAR in this regard.

The AAR observed that from analysis of provisions under section 143(2) and 142(1) of the Act, it is evident that by issue of notice under section 143(2) only, the AO assumes jurisdiction to adjudicate all the questions arising out of the return. Accordingly, only when the issues are shown in the return and notice under section 143(2) is issued, the question raised in the application will be considered as pending for adjudication before the Income-tax Authorities.

Thus since the notice under section 143(2) was issued after the date of filing the application, the application was admitted by the AAR.

[4] TS-551-ITAT-2013(AGR)
[5] TS-621-ITAT-2013(Mum)
[6] TS-648-AAR-2013 (AAR)
[7] TS-649-AAR-2013 (AAR)

II. Overseas Rulings

Isha Sekhri
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1. *Deutsche Bank AG[8] (Philippines Supreme Court)*

Philippines Supreme Court ruled failure to comply with time requirement for tax treaty relief application does not bar taxpayer from treaty benefit

The Supreme Court of the Philippines ruled in favor of Deutsche Bank AG, Manila Branch (DB Branch) and held that the failure to strictly comply with the domestic law requirement under Revenue Memorandum Order No. 1-2000 to file a tax treaty relief application (TTRA) 15 days prior to the transaction should not deprive a taxpayer of the benefit of a tax treaty. The transaction was the remittance of the branch profits to DB Branch's German Head Office, which would give rise to branch profits remittance tax (BPRT). Few important observations of the SC were:

- Every treaty in force is binding upon the parties, and obligations under the treaty must be performed by them in good faith.
- Each State's domestic laws must ensure that the reliefs granted under a given income tax treaty are available to the parties who are entitled to such reliefs and the Bureau of Internal Revenue should not impose additional requirements that will negate availability of the reliefs provided for under the treaty.
- The 15-day period for filing the TTRA under the domestic law should not deter entitlement to the tax treaty provision/benefit, since, to do so would constitute a violation of the duty required by good faith in complying with a tax treaty. At most, the TTRA should merely operate to confirm the entitlement of the taxpayer to the relief under the treaty, not denial solely due to failure to produce it.
- The obligation to comply with a tax treaty must take precedence over the domestic law. Non-compliance with tax treaties has negative implications on international relations, and unduly discourages foreign investors.

Source:
http://sc.judiciary.gov.ph/jurisprudence/2013/august2013/188550.pdf

2. *Brambles France[9] (Spanish Supreme Court)*

Spanish capital gains tax rules found to be discriminatory by Supreme Court

A French company sold its shares in a Spanish subsidiary in 2002 and made a capital gain of EUR15.3 m on the sale, which attracted Capital Gains Tax ('CGT') rate of 35 percent. The French company had a substantial ownership in the subsidiary i.e. in excess of 25 percent. Accordingly, the capital gains were taxable under Spanish law, and Article 13-2 of the Spain/France tax treaty provided for concurrent taxation by both countries. Under Spanish domestic law, resident companies may claim relief from CGT arising from sales of shares, provided a minimum 5 percent ownership criterion is met. CGT is calculated at the standard corporation tax rate (35 percent at the time), but a tax credit may be claimed on the part that is in fact derived from undistributed profits.

CGT relief aims to avoid economic double taxation, so that the after-tax profits of a Spanish company may flow through another Spanish company without further taxation. A similar tax credit would have applied for dividends, providing the shareholder held a minimum 5 percent stake. The Spanish subsidiary had undistributed profits of EUR 3.6m. Accordingly, the taxpayer was denied a EUR1.25m tax credit.

As there is no CGT relief for non-residents, the key issue in this case was to determine whether there was illegal discrimination. According to the Supreme Court, resident and non-resident companies were in a comparable situation despite the different tax treatment. Therefore, the Court found there was illegal discrimination against non-resident taxpayers if tax relief was denied. The Court's reasoning was primarily based on existing ECJ case law, namely the cases Denkavit Internationaal BV (C-170/05) and Commission v. Spain (C-562/07). As the decision solely relied on EU law, the Court refrained from looking at whether there was prohibited discrimination under treaty law.

The Supreme Court also held that the capital gains tax provisions were against the EU principle of freedom of capital, even though the non-resident taxpayer held a substantial participation in the Spanish subsidiary. As a general rule, the EU principle of freedom of capital is extendable to non-EU countries, whereas the principle of freedom of establishment is limited to intra-EU movements. In addition, as it solely relied on EU law, the Court refrained from looking at double tax treaty law and check whether the French parent was able to claim a foreign tax credit in France.

Source: http://regulytics.com/2014/02/17/spanish-capital-gains-tax-rules-found-to-be-discriminatory-by-supreme-court/

3. *Name not available (Spanish Tax Authority)*

Spanish Tax Authority issues ruling expanding capital gains tax to indirect transfer of Spanish real estate by Luxembourg entities

The Spanish tax authorities have recently taken a step forward towards the taxation of capital gains on the transfer of Spanish real estate through structures including Luxembourg companies. In the case, the Luxembourg company held Dutch and German companies which in turn held Spanish companies and the latter directly held real estate in Spain. The Spanish tax authorities; notably, the Dirección General de Tributos, have issued a binding ruling dated 10 September 2013 whereby capital gains realized on an indirect transfer of Spanish real estate by Luxembourg entities, should be subject to tax in Spain at a rate of 21% under national Non-Resident Income Tax Law.

[8] G.R. No. 188550 August 19, 2013
[9] Appeal No 1374/2011

International Tax Updates - India and Global

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I. India

1. Guidelines notified for Application of General Anti Avoidance Rule (GAAR)

CBDT has notified the following Rules for application of GAAR. These rules have been notified vide Income-tax (17th Amendment) Rules, 2013 and are applicable from 1st April 2016:

Rule 10U: Exemption from applicability of GAAR to (a) arrangements where tax benefit is lower than Rs. 3 crores; (b) FII (subject to certain conditions); (c) investment by way of offshore derivative instruments, (d) income where transfer of investment has taken place before 30th August 2010.

Rule 10UA: Consequences to be restricted to that part of an arrangement that is declared to be an impermissible avoidance arrangement.

Rule 10UB: Notice, Forms notified for reference to the Commissioner u/s 144BA.

Rule 10UC: Time limits notified for reference to the Commissioner u/s 144BA.

Source: Notification No. 75/2013/ F.No.142/19/2013-TPL dated 23rd September 2013

2. Form of application notified for obtaining advance ruling on applicability of GAAR to an arrangement

CBDT has notified Form No. 34EA vide Income-tax (18th Amendment) Rules, 2013 as the form of application to obtain an advance ruling on whether an arrangement, which is proposed to be undertaken by any a resident / non-resident, is an impermissible avoidance arrangement.

Source: Notification No. 76/2013/ F.No.142/19/2013-TPL dated 24th September 2013

3. CBDT notifies Cyprus as a 'notified jurisdictional area' for the purpose of Sec 94A

Due to non-provision of information as requested by the Indian tax authorities under the exchange of information provisions of the India-Cyprus DTAA, CBDT notified Cyprus as a 'notified jurisdictional area' under section 94A of the Income-tax Act, 1961 through this notification. CBDT has also stated brief implications of issuance of this notification in the corresponding Press Release:

1. Application of transfer pricing regulations for transactions with a person in Cyprus;
2. Non-deduction of payment made to any financial institution in Cyprus if such payment is made without furnishing authorization in Form 10FC [viz. to call for further information];
3. Non-deduction / Non-allowance of any expenditure if information and documents as prescribed under Rule 21AC(5) are not maintained;
4. Amount received from a person in Cyprus to be treated as income if satisfactory explanation is not afforded with regard to the source of funds in the hands of such remitter;
5. Payment made to a person located in Cyprus to be subject to withholding tax @ 30 per cent or a rate prescribed in Act, whichever is higher.

Source: Notification 86/2013/F.No.504/05/2003/FTD-I dated 1st November 2013 & Press Release dated 1st November 2013

4. Clarification regarding applicability of provisions of Sec. 144C

CBDT has clarified that Section 144C would be applicable to any order which proposes to make variation in income or loss returned by an eligible assessee on or after 1st October 2009 and not restricted to orders relating to assessment years on or after assessment year 2010-11 as inadvertently mentioned in Circular No.5/2010 dated 03.06.2010.

Source: Circular No. 09/2013 dated 19th November 2013.

5. Bilateral Investment Promotion and Protection Agreement (BIPPA) signed between India and Government of UAE

India entered into BIPPA with Government of UAE to boost investment flows between the countries.

Source: Press Release dated 12th December 2013

6. India enters into DTAA with Republic of Macedonia

The GOI has entered into a DTAA with Republic of Macedonia, the salient features of which include the following:

- Lower withholding tax of 10% for taxation of dividend, interest and royalty in the source country;
- Article on Limitation of Benefit;
- Provisions enabling Exchange of Information, Tax Examinations Abroad and Mutual Assistance in Collection of Taxes.

Source: Press Release dated 17th December 2013

7. India enters into Tax Information Exchange Agreement (TIEA) with San Marino

The GOI has entered into TIEA with San Marino which is based on international standard of transparency and exchange of information.

Source: Press Release Dated 20th December 2013

II. Global

1. Ireland publishes law on "stateless" companies

On 15 October 2013, the Irish Minister for Finance announced proposals to prevent "stateless" Irish incorporated companies avoiding a charge to Irish corporation tax on their profits. The primary test of corporate residence in Ireland is the location of "central management and control." From 1 January 2015, an Irish incorporated company (which was incorporated before 24 October 2013) can no longer avoid a charge to Irish tax through maintaining central management and control in a EU Member State or a territory with which Ireland has a DTAA, where such a company would have been tax resident in that relevant territory had they also been incorporated there. For companies incorporated in Ireland on or after 24 October 2013, the new legislation takes immediate effect and therefore newly incorporated companies in Ireland, which are managed and controlled outside of Ireland will need to carefully adhere to the new rules going forward.

2. OECD invites public comments on a discussion draft on technical changes to be included in the next update to the Model Tax Convention

The OECD Committee on Fiscal Affairs has invited public comments on a discussion draft on technical changes to be included in the next update to the OECD Model Tax Convention including proposals for changes to the Model Tax Convention resulting from the work of Working Party 1 on Tax Conventions and Related Questions on a number of technical issues related to the Model Tax Convention. It is proposed that these changes be part of the next update to the OECD Model Tax Convention, which is currently scheduled to be finalised in 2014.

Source: http://www.oecd.org/tax/treaties/oecd-invites-public-comments-on-discussion-draft-on-technical-changes.htm

3. OECD report recommends new approaches to encouraging business innovation via tax incentives

A new OECD report, Supporting Investment in Knowledge Capital, Growth and Innovation, stresses that effective government policies aimed at encouraging business innovation in knowledge-based capital - described as a range of intangible assets beyond just research and development - are essential for growth in the current global economy.

4. OECD invites public comments on a discussion draft on proposed changes to the provisions dealing with the operation of ships and aircraft in international traffic

The OECD Committee on Fiscal Affairs has invited public comments on a discussion draft on proposed changes to the provisions dealing with the operation of ships and aircraft in international traffic by 15 January 2014. These changes address various issues related to the application of the provisions of the OECD Model Tax Convention applicable to international transport. These provisions include Article 8, which deals with profits from the operation of ships and aircraft in international traffic and boats engaged in inland waterways transport; paragraph 3 of Article 15, which deals with the taxation of employees who work on such ships, aircraft and boats as well as the definition of the term "international traffic" in subparagraph 3 e) of Article 3 of the Model Tax Convention.

Source:
http://www.oecd.org/tax/treaties/httpwwwoecdorgtaxtaxtreatiesoecd-consults-on-mtc-changes-re-international-traffic.htm

5. OECD publishes comments received on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles and White Paper on Transfer Pricing Documentation

On 30 July 2013, the OECD invited comments from interested parties on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles and on the White paper on Transfer Pricing Documentation. The OECD has published the comments received on the revised discussion draft and the white paper.

Source: http://www.oecd.org/tax/transfer-pricing/comments-intangibles-discussion-draft.htm *http://www.oecd.org/tax/transfer-pricing/public-comments-white-paper-transfer-pricing-documentation.htm*

6. OECD publishes compliance ratings for 50 jurisdictions

The OECD's Global Forum for Transparency & Exchange of Information has published compliance ratings for 50 jurisdictions.

Source:

http://www.oecd.org/tax/transparency/global_forum_ratings.pdf

7. OECD plans a tax Information superhighway

In April 2013, the G5 (France, Germany, Italy, Spain and the UK) agreed to develop and pilot a multilateral automatic tax information exchange. In their announcement they called on other EU Member States to join the pilot; since April 2013 more than 30 countries are known to have endorsed this plan.

Meetings took place at the OECD in the week commencing 14 October to discuss at an operational level how to progress the plans that were set out in its report titled A Step Change in Tax Transparency (the Report), which was issued in June 2013 at the request of the G8. The stated aim of the meetings was to develop a model competent authority agreement and a common reporting standard with a view to putting this to the OECD's Committee for Fiscal Affairs for approval in early 2014. Industry responses to this have been generally supportive in that the OECD is seen as best placed to develop a true global standard.

8. OECD meets with business on base erosion and profit shifting action plan

On 1 October 2013, the OECD held a meeting with the Business and Industry Advisory Committee (BIAC) to the OECD on the Action Plan on Base Erosion and Profit Shifting (BEPS). The Action Plan, which identifies 15 focus areas for OECD work on BEPS over the next two and a half years, was issued by the OECD on 19 July 2013 in connection with a meeting of the G20 Finance Ministers and Central Bank Governors. On July 2013, the OECD issued more detailed documents on two of the Action Plan focus areas, transfer pricing for intangibles and enhanced transfer pricing documentation. The OECD-BIAC meeting was the first formal opportunity for business representatives to engage with the OECD on the Action Plan and the 15 focus areas. In the Action Plan, the OECD expressed a commitment to consult with the business community as it works to develop recommendations in each of the focus areas.

Experts Speak

Safe Harbor Rules: Escape from rough seas of transfer pricing

Sagar Wagh, Senior Tax Professional

The Finance (no.2) Act, 2009 introduced section 92CB in Income Tax Act, 1961 ('the Act') with retrospective effect from 1st April 2009, which provided that determination of arm's length price would be subject to safe harbor rules. The definition of 'safe harbor' according to explanation to section 92CB means circumstances in which income tax authorities shall accept the transfer price declared by the assessee. Further, the said section also empowered Central Board of Direct Taxes ('the board') to frame safe harbor rules.

In absence of corresponding delegated legislation i.e. safe harbor rules framed by the board, the section 92CB was non-operational for period of four years. Finally, on 18th September 2013, the board inserted Rules 10TD to Rule 10TG in Income Tax Rules, 1962 ('the Rules') containing provisions relating to safe harbor rules.

The rules provide safe harbors only with respect to international transactions and no safe harbor provisions have been introduced in respect of specified domestic transactions.

The international transactions which are eligible to take the benefits of safe harbor rules are as under:

a) provision of software development services

b) provision of information technology enabled services ('ITES')

c) provision of knowledge process outsourcing services ('KPO')

d) provision of corporate guarantee, where the amount guaranteed,

(i) does not exceed one hundred crore rupees; or

(ii) exceeds one hundred crore rupees, and the credit rating of the associated enterprise (AE), done by an agency registered with the Securities and Exchange Board of India, is of the adequate to highest safety;

e) provision of contract research and development services wholly or partly relating to software development

f) provision of contract research and development services wholly or partly relating to generic pharmaceutical drugs;

g) manufacture and export of core auto components; or

h) manufacture and export of non-core auto components,

As per Rule 10TB of the Rules, for assessee to be eligible for availing the option of safe harbor rules:

i) it should provide software development services, ITES services, KPO services or contract research and development services to its foreign principal AE and it should bear insignificant risk in respect of such services

ii) it should be engaged in manufacture and export of core or non-core auto components and should derive ninety percent or more of its turnover from original equipment manufacturer ('OEM') sales

iii) it has provided intra-group loan or guarantee to its AE

Further, the rules provide that assessee providing software development services, ITES services, KPO services or contract research and development services bears insignificant risk in respect of international transaction when :

a) the foreign principal AE performs critical functions like conceptualization and design of product and provides the strategic direction and framework through its employees

b) the eligible assessee performs the work assigned to it by its foreign principal AE for which it is remunerated on cost plus basis

c) the capital and funds and other economically significant assets including intangibles required, are provided by foreign principal AE. All the economically significant risks in respect of controlled transaction under consideration are borne by foreign principal and not only contract but also conduct of the parties to the transaction demonstrates such allocation of risks

d) the eligible assessee works under direct supervision of foreign principal AE or sister AE which controls, directs and monitors the activities performed by the assessee

e) the assessee has neither legal or economic ownership on any intangible generated or outcome of any intangible generated or arising during the course of rendering of services, and such ownership vests with the foreign principal AE

The actual conduct of business between taxpayer who is captive service provider and its AE will be the most important factor in determining whether the taxpayer adheres to the functional profile of low risk service provider performing insignificant function, owning insignificant assets and bears negligible risk, to be eligible for availing the benefits of safe harbor rules.

Rule 10D of rules gives safe harbor limits for different categories which are reproduced below:

Sr. no	Eligible international transaction	Transaction value	Safe harbour ceiling
1.	Software development services/ITES services with insignificant risk	Upto INR 5 billion	20% or more on operating costs
		Above INR 5 billion	22% or more on operating costs
2.	KPO services with insignificant risk	No limit prescribed	25% or more on operating costs
3.	Contract R&D services wholly or partly relating to software development services with insignificant risk	No limit prescribed	30% or more on operating costs
4.	Contract R&D services wholly or partly relating to generic pharmaceutical drugs with insignificant risk	No limit prescribed	29% or more on operating costs
5.	Intra-group loan to wholly owned subsidiary	Value of loan upto INR 500 million	Interest rate ≥ base rate of SBI on June 30 of the relevant year plus 150 basis points
		Value of loan above INR 500 million	Interest rate ≥ base rate of SBI on June 30 of the relevant year plus 300 basis points
6.	Explicit corporate guarantee to a wholly owned subsidiary	Value of guarantee provided up to INR 1 billion	Commission/ fee should be charged at the rate of 2% or more per annum of the amount guaranteed
		Value of guarantee provided above INR 1 billion (adequate to highest safety rating)	Commission/ fee should be charged at the rate of 1.75% or more per annum of the amount guaranteed
7.	Manufacture and export of core auto components	No limit prescribed	12% or more on operating costs
8.	Manufacture and export of non core auto components	No limit prescribed	8.50 % or more on operating costs

The safe harbor rules in respect of certain eligible transactions like, contract research & development services, software development services, KPO services, ITES, contract R&D services do not adhere to arm's length principle, as the safe harbor rules expects the low risk captive service providers to be remunerated with high cost plus returns by their foreign AEs, regardless of the functional profile of such captive service provider. Such expected cost plus return may be considerably higher than that earned by comparable service providers performing similar functions and bearing similar risks in uncontrolled transactions.

It is important to note that, remunerating Indian captive service providers with high cost plus return might lead to less taxable income being reported in tax jurisdiction of foreign AEs, which might be unacceptable to revenue authorities in those jurisdictions, who may resort to make transfer pricing adjustments in hands of AE. This may result in economic double taxation. Hence, it is doubtful whether such taxpayers who are captive service providers will opt for safe harbor provisions.

The Indian safe harbor rules have not exempted the tax payers who will opt for safe harbor regime from mandatory documentation and reporting requirements which comprise of data collection in respect of comparable uncontrolled transactions, selection and application of most appropriate methods and arriving at arm's length price. This is clear deviation from the guidance given on safe harbour by OECD Transfer Pricing Guidelines.

Further, safe harbor in respect of intra-group loan clearly deviates from the established jurisprudence laid down by tribunal rulings which stipulate that, loan given to foreign AE in foreign currency should be benchmarked with reference to international rate being Libor and not Indian Prime Lending Rate (PLR), immaterial of the fact that loan is sourced in Indian rupees.

The safe harbor rules unilaterally restricts the right of non-resident taxpayers, who have opted for safe harbor, from taking the benefits of Article 25 Mutual Agreement Procedure of the Double Taxation Avoidance Agreements entered into between India and their respective resident jurisdictions. Such restriction has aggravated the risk of potential economic double taxation.

It is to be noted that, even if the taxpayer earns remuneration as stipulated by safe harbor, the tax authorities are not bound to accept that taxpayer opting for safe harbor is eligible to avail the benefits of such rules or the transaction is an eligible transaction as per safe harbor rules. This may not only trigger a new set of litigation but also the tax authorities may demand higher consideration to be earned by taxpayer than stipulated under safe harbor rules.

Further, the assessee will not be allowed to opt for safe harbor rules in respect of transaction enter into with AE located in notified jurisdictional area under section 94A of the Act or in a no tax or low tax country or territory.

The assessee opting for safe harbor will also not be allowed to avail the range benefit under second 92C(2) or be allowed to make any comparability adjustment to its margins.

The assessee can opt for provision of safe harbor rules for one or more assessment years subject to maximum period of five assessment years. The assessee should exercise its option for safe harbor in Form 3CEFA to the assessing officer on or before due date of furnishing return for assessment year or first of such assessment year (in case option is exercised for more than one year). Any rejection of the option exercised by the assessee shall be by the way reasoned order passed after hearing the assessee. The assessee shall have right to file objections with the commissioner against any adverse finding regarding the eligibility.

Though the safe harbor rules as currently enacted are unilateral in nature and also pose significant risks of potential economic double taxation, it is important to acknowledge the fact that, Indian safe harbor regulations are at extremely nascent stage, and in my view, in future India may provide for or enter into bilateral safe harbor MOUs with other countries so as to eliminate the problems of arriving at non-arm's length results and risks associated with potential double taxation.

IFA - WRC

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