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Safe Harbour Rules – 'Waiting for Godot'

The Finance Act of 2009 empowered the Central Board of Direct Taxes – the apex Indian administrative body on tax issues - to formulate safe harbor rules in connection with Transfer Pricing. In his budget speech of July 2009, the then Finance Minister, Pranab Mukherjee said:

"To reduce the impact of judgemental errors in determining the transfer price in international transactions, it is proposed to empower the Central Board of Direct Taxes to formulate safe harbour rules,"

However, two years have gone past and the rules are yet to be framed and operationalised. It is hoped that some positive action would be witnessed in the budget for the next fiscal ie 2012 which is also expected to roll out the much awaited Direct Tax Code.

Broadly speaking, Transfer Pricing safe harbor rules stipulate conditions based on profitability thresholds (which may vary across industries) that exempt taxpayers from detailed documentation requirements and challenge by Revenue authorities. Apparently, the reason why safe harbor regulations are held up is the lack of consensus within the Government on various issues. For example, the level of mark-up for IT/ ITES companies witnesses a wide range from 5 to plus 50 percent (taking into account independent entrepreneurial companies of all hues). Equally controversial is the issue of core versus non core business activities. While it is suggested that safe harbor rules should cover only the non core business activities, the Government is currently grappling with clarity on the distinction between core and non core areas.

Interestingly, the Direct Tax Code regime also envisages the introduction of Advance Pricing Arrangement ('APA') mechanism that seeks to bring greater certainty in Transfer Pricing by committing tax authorities and the taxpayer to pre-agreed transfer pricing solutions. By mitigating tax/ Transfer Pricing risk, it is hoped that safe harbor rules and the APA mechanism would give the much needed fillip to multinational companies investing in India.

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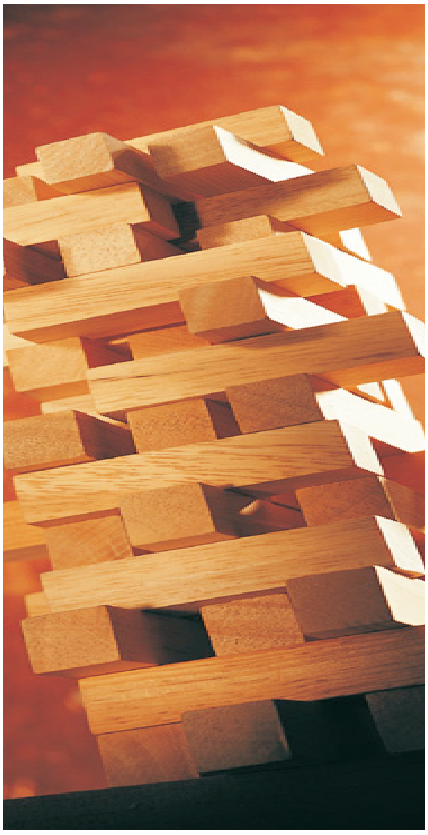

Having said that, APA mechanism may be better suited for complex and high value transactions wherein characterization of entity or the choice of Transfer Pricing methodology is a core issue. Safe harbor rules on the other hand would serve as legislative havens for cases where uncertainty shrouds the basic mark-up issue. For example, the cost plus captive units operating in the information technology space, with existing mark-ups under attack by Revenue authorities, are classic examples of entities expected to benefit from safe harbor rules.

The Indian tax audit environment is perceived to be fairly aggressive insofar as Transfer Pricing is concerned. Not surprisingly, Transfer Pricing planning invariably tops the agenda for any corporate discussion on tax risk mitigation in India. In the interest of business and to bolster investor confidence, the Government would do well to take a stand on the safe harbor rules and set the ball rolling. For one, the safe harbor rules would surely put to rest the unnecessary controversy and the tirade of cases around the mark-up issue for IT/ ITES companies. With these issues being resolved, perhaps the tax authorities and taxpayers alike can shift their focus to more real and meaningful issues surrounding international taxation.

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