

NASSCOM[®]

PRE-BUDGET MEMORANDUM 2014-15

Transfer Pricing Issues

June 2014

Executive Summary

The IT sector is characterized by fast changing technologies leading to new business models, service delivery methods and platforms. These have far reaching implications not only on business operations, lives but also the policy and resulting business environment. It is therefore critical that India keeps pace with the dynamic nature of the technology, businesses and governance. We urge the Government to consider adopting collaborative approach with the Industry as policies and rules need to be tweaked and modified, framed anew and revisited for its relevance.

Entrepreneurship and innovation are critical for the growth in an increasingly competitive and volatile world. The IT sector in India has been at the forefront on enabling entrepreneurship in the country, building global success stories and contributing to Indian exports, employment and image. With over 15000 technology Start-up and IT SMEs today, it is the second largest hub globally, after China.

A Government-Industry partnership is critical for helping build this emerging opportunity for technology entrepreneurship in the country. Leading countries like US, UK, Singapore, and Chile have launched several start-up focussed programs. We propose a **India Technology Entrepreneurship Mission (ITEM)** should enable local and global companies to set up in their country and build intellectual property. There is a need for appropriate budgetary allocation to enable and ensure funding and ease of doing business for small businesses and start-ups.

IT-led interventions can bring about **transformation and bridge developmental gaps** in the country. **Adoption of IT** and technology services is critical, particularly in education, healthcare, governance. While IT/ITeS can provide solutions, effective adoption requires close engagement between Government and industry bodies, **focused financial investments and supporting procurement and implementation policies.**

While the industry has created a strong focus on sustaining growth, there are a number of tax issues that are creating hurdles in doing business for companies, increasing litigation, uncertainty and impacting future investment. These prevailing issues need immediate resolution.

TARC has been constituted with a mandate to simplify and streamline the existing processes under the existing provisions, but there should be an **effort to go beyond existing rules to enable simplification.** We should not shy away from adopting substantially different approach from the past to achieve the collective objective of economic growth and business friendly environment.

It is very important that approach to taxation of the IT sector be carefully considered. The business models are significantly different and flexible. We recommend that there be a **platform for regular Government-Industry interaction on various new developments and emerging trends** in businesses with a focus on its implication on both direct and indirect taxation. Further, IT serves to overcome geographical distances and boundaries, and this is a critical success factor for the sector, but also complicates the tax administration. Therefore, a collaborative approach should be primary. Several advisory councils currently support interaction, and this should be maintained.

Several issues are elaborated in subsequent pages. Many of these issues have been in discussion for a couple of years now, and the Industry is hopeful for a closure on these. The issues of **software product**

companies need attention as they are primarily SMEs, struggling with funding constraints and cash flow issues arising due to tax liabilities.

The explanations inserted in the Finance Act 2012 retrospectively are unfair to the Industry. **TDS liabilities, associated penalties arising out of royalty implications** are a cause of concern. Further, implications of royalty on Internet downloads of software and ancillary services like maintenance and upgrade, as well as on telephone and telecom services is altering tax consequences. This needs to be withdrawn and aligned to International practices.

Indian IT companies are increasingly going global. There is a need to **re-examine the foreign tax credit provisions** and initiate a discussion to ensure that it is abreast with business trends and supportive of global Indian Industry, a significant change from the past, where MNCs hardly emanated from India.

The Indian IT Industry has been facing several **unwarranted assessments on account of transfer pricing** adjustments. While the APA program has taken off, and companies are considering adoption, the Safe harbour notifications have had limited uptake. Consequently, most companies have opted for the TP assessment and audit option, and subjective assessments of Arm's Length Price (ALP) continued leading to high mark-up contrary to market conditions and inconsistency for lack of guidance. As apprehended, Industry sub-categorisation in the safe harbour notification was seen to influence the audits, and in a majority of the cases, the safe harbour margins were seen to be the base instead of the outside limit in the assessments.

There is a need to **re-examine the safe harbour notifications** to reflect the business conditions and evaluate reasons as to why companies have not adopted it despite of the certainty that it offers. Rules and guidance should be framed to notify the metrics for transfer pricing adjustments. Further the Act maybe amended to allow use of Interquartile Range Method and Multiple Year Data for ALP computation.

The IT service exporters are entitled to **service tax refund** paid on input services used in the export of IT services. However, there has been significant denial / pendency in service tax refunds to SEZ and STPI units on one pretext or the other (as enumerated in the detailed memo) which the exporters of IT services are entitled to. While clarifications have been issued, and process simplification has been attempted, obtaining these refunds continue to be a challenge. We request the Government to focus on the issue for a smooth and predictable refund process. We have in our recommendations also **proposed a duty drawback scheme for software services** in line with duty drawback allowed for goods. This has the potential to simplify and also reduce the work load of revenue if implemented with suitable safeguards.

There is **ambiguity on treatment of software being "goods" or "services"** resulting in dual taxation. Both Central and State authorities have been demanding taxes on supply of software. Further introspection is required to remove such duality.

There are various issues related to filing of taxes, verification, form generation etc. that impose administrative and procedural burden. We have suggested some procedural changes and simplification most of which have been discussed with the TARC as well, for your consideration.

There has been a complete overhaul of the Service Tax regime with the introduction of the **Negative List and Place of Provision of Services Rules**. Several **teething problems** have cropped up and there are serious apprehensions related to treatment of head office and branch office transactions and unnecessarily burdening the refund mechanism, R&D testing services not being treated as exports even if the clients are overseas etc.

The IT sector is technology intensive with rapid evolution of information technology platforms, business delivery models and services. Companies invest in training and R&D. Currently R&D incentives in India are targeted towards the manufacturing sector. There is ambiguity on treatment of production of computer software as a manufactured product. The sector therefore is denied access to various existing R&D promotion schemes. There is a need to develop a **tailored incentive model for R&D in the IT/ITeS sector**. Further, **disregarding investments in IT** and associated efficiency enhancement tools **for investment allowance** is detrimental to their adoption and will have long term impact on the competitiveness of the Indian manufacturing sector. This barrier can be easily removed.

The IT/ITeS sector is driven by people and talent. The sector would be at a **disadvantage in leveraging proposed investment linked incentives**. With 20% MAT on SEZ profits, and the phasing out of tax benefits of the STPI, there is currently no sector focused incentive for the Industry.

It is important to note that with over **15000 technology start-up and IT SME's**, second only to China, it is imperative that technology driven companies are supported and incentivized to operate from India, as they continue to address global markets. Many countries are actively wooing technology driven start-ups and offer a more business friendly environment in addition to bringing them closer to the market. The Government therefore should **evaluate and design support and incentive schemes** demonstrated to be effective around the world.

Exports from IT sector continue to fill the large gap in India's external trade balance. Promotion of Tier II/III cities would be key to inclusive growth, and the sector can largely benefit from this movement with enabling support of the Government in terms of infrastructure and easing of business process compliances.

The new companies Act introduced the revolutionary concept of mandatory CSR. However, there are doubts on **treatment of CSR expenses in accounting terms**. As companies are still formulating the programs and details, there is a need for immediate clarification to safeguard against confusion and litigations at a later date.

Ecommerce is now a growing Industry, with several Indian entrepreneur led organisations having emerged leaders. Business models are evolving and there is need to understand online marketplaces which is a platform to Merchants/ Manufacturers to sell their products, for tax implication. **Levying excise duty on order fulfilment services by ecommerce companies** is not manufacturing and there should be suitable clarifications to ensure that the field officers are updated and understand the new evolving business models.

We request the Government to consider the NASSCOM recommendations as positioned in the Pre-Budget Memorandum 2014-15.

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JOINT GOVERNMENT-INDUSTRY EFFORTS FOR STRATEGIC GROWTH

The IT sector is characterized by fast changing technologies leading to new business models, service delivery methods and platforms. These have far reaching implications not only on business operations, lives but also the policy and resulting business environment. It is therefore critical that India keeps pace with the dynamic nature of the technology, businesses and governance. We urge the Government to consider adopting collaborative approach with the Industry as policies and rules need to be tweaked and modified, framed anew and revisited for its relevance. Our specific recommendations are:

Recommendation

1. Taxation

It is very important that approach to taxation of the IT sector be carefully considered. The business models are significantly different and flexible. We recommend that there be a platform for regular Government- Industry interaction on various new developments and emerging trends in businesses with a focus on its implication on both direct and indirect taxation. Further, IT serves to overcome geographical distances and boundaries, and this is a critical success factor for the sector, but also complicates the tax administration.

Separate Advisory Councils on International Tax and Indirect Taxes were constituted in 2012, chaired by the Revenue Secretary, with participation from senior officials and industry members including trade associations. Such consultative groups should continue to operate. While the TARC has been constituted with a mandate to simplify and streamline the existing processes under the existing provisions, there should be an effort to go beyond existing rules to enable simplification.

2. Entrepreneurship and small business

Entrepreneurship and innovation are critical for the growth in an increasingly competitive and volatile world. The IT sector in India has been at the forefront on enabling entrepreneurship in the country, building global success stories and contributing to Indian exports, employment and image.

With major technology shifts taking place – adoption of cloud, mobility, social media, big data, there is an opportunity to enable and build the next set of technology leaders. These companies would focus on building intellectual property that leverage such technology disruptions and create solutions for India and the global market. With over 15000 technology Start-up and IT SMEs today, it is the second largest hub globally, after China.

A Government-Industry partnership is critical for helping build this emerging opportunity for technology entrepreneurship in the country. Leading countries like US, UK, Singapore, and Chile have launched 'Start-up programs' that enable local and global companies to set up in their country and build intellectual property. The following recommendations would enable the facilitating of a vibrant technology entrepreneurial ecosystem in India:

- a. Set up India Technology Entrepreneurship Mission (ITEM), whose sole focus is to establish a vibrant entrepreneurial ecosystem in India. The Mission's mandate, as one single entity within the Governments both at the National and State levels, will require it to pursue the task of facilitating entrepreneurs and entrepreneurship, exclusively.
- b. Partnership with industry to provide access to seed capital funding, incubation, market access etc.
- c. Create a Rs. 5000 crore 'Fund of Funds' to seed early stage ventures

- d. Enable ease of doing business for small businesses and start-ups and revise the threshold limits for SMEs in the Income Tax Act, making it relevant in the prevailing business conditions
 - e. Enable small businesses to participate in government projects at central and state levels without compromising on quality and specifications.
 - f. Evaluate existing tax treaties and remove any differential tax treatment that puts the domestic investor at a disadvantage and encourages 'round-tripping' of investments
 - g. Create a separate regulatory approach for Angel investments, which are a lifeline for the technology start-up community due to lack of support of public financial institutions. Specific recommendation on additional income tax on distributed income for buyback on unlisted share arising due to fair market value of share is detailed in the document
 - h. Encourage setting up in Tier II/III locations
 - o Policy framework to encourage new companies to emerge in tier 2 / 3 cities, thus balancing the regional development objective.
 - o Structural inefficiencies like power, transportation should be compensated for, by defraying expenses incurred to overcome infrastructural constraints. E.g. weighted deduction for expenses like need to generate power on account of lack of availability or providing transportation for employees and expenses made for security due to lack of reliable transportation facilities. A reimbursement model has limitations based on experience in the past, therefore, weighted expense deductions maybe considered.
3. Domestic IT Adoption: There is scope for IT-led interventions to bridge developmental gaps of the country, particularly in rural India
- a. Education: plagued by lack of infrastructure and teachers;
 - b. Healthcare : lack of access and high cost
 - c. Governance: address Information asymmetry, lack of transparency, lack of credible citizen information and stakeholder participation
 - d. Ensure e-enabled delivery of citizen services
 - e. Ensure last mile connectivity to increase access to internet from current rate to globally accepted standards.

While IT/ITeS can provide solutions, effective adoption requires close engagement between Government and industry bodies, focused financial investments and supporting policies.

4. Cyber security: For globalization, just as it is an imperative to gain trust in the nation's capability of securely exporting goods and services, similarly it is equally important to secure the electronic transformation of economy. Cybersecurity therefore is an important component of national security, from the perspective of economic contribution and its potential adverse impact to critical assets of the nation. Increasing reliance of critical sectors on information technology for improving productivity, efficiency and governance on the flip side add to worries related to security. This is also true for the Government as it relies on ICT for delivery of its services and outreach.

This warrants dedicated and significant allocation of budgetary resources to enhance national capability to address challenges of cyber security, establish required institution framework, facilitate efforts of securing economic and strategic assets, carry research and development and enhance skills & competence in the area. We recommend that the current budget makes optimal allocation for the 4 key areas outlines above, while the details are worked out separately.

SUMMARY

S.no	Issue and Recommendations	Justification
SOFTWARE PRODUCT TAXATION ISSUES		
1.	<p>Dual levies on software-vat and service tax For all Internet downloads (license, product key, upgrades etc.), and other forms of services like maintenance contracts, there is a dual levy of both VAT and Service Tax.</p> <p>Recommend clarification such that VAT and Service tax dual burden is removed. For software transactions which involve both a product and associated services, the services component should be subject to service tax alone, and the product value should be subject to VAT only.</p>	<p>Software companies, primarily SMEs face an uncertain and unfair tax environment that is blocking capital.</p> <p>As software products from India emerge, and companies develop a business model where services are also bundled with the product, this issue of duality will impair competitiveness. Many software SMEs, for lack of clarity are advised to pay both VAT and Service Tax to avoid penalties. VAT is also levied on the Service tax component.</p>
2.	<p>Pending TDS refunds SMEs and start-up software companies suffering TDS @ 10% Actual tax liability on profits is far lower than the TDS liability.</p> <p>Recommend Lower TDS rates for software SMEs and start-up companies. Consider adjusting pending refunds to future TDS liability.</p> <p>Banks to consider offering loans to companies based on pending TDS refunds, as if it is a book debt.</p>	<p>Profitability of SMEs and software product companies are lower. Further, product development requires investment and time before they are launched. A 10% TDS on every transaction is high for such companies.</p> <p>Financing difficulties for SMEs and start-up companies due to low asset base and non-consideration of technology as an asset to offset risk further compounds the issue of blocked capital.</p>
3.	<p>Increase threshold limits of section 194J TDS @ 10% on payments made for acquisition of software for amount greater than Rs. 30,000 in a financial year</p> <p>Recommend This amount be increased to Rs. 3.00 lakh in a financial year. We request that the criteria of setting the limits be shared and Industry can share relevant data to update the limit regularly.</p>	<p>Threshold limit is low and does not reflect current business environment in terms of pricing trends</p>
4.	<p>Clarification on requirement to deduct TDS on upgrade and subscriptions Payment for Software Ancillary Services such as AMC's, Upgrade Fees, Subscriptions, etc. is "Royalty" u/s 194J r/w 9(1)(iv) Explanation 2</p> <p>Recommend Clarify for Payments towards services like AMC's, Upgrade Fees, Subscriptions, etc. there is no "Royalty"</p>	<p>They do not involve transfer of rights, or grant of license but involve only payments of consideration for services</p>

5.	Inadequate abatement for packaged / canned software for payment of excise duty Abatement of 15% is allowed from RSP to arrive at the value of Packaged Software. The taxes on the product amount to 22% of the RSP and the notified abatement of 15% is not adequate Recommend abatement be increased to 30%.	This notified abatement of 15% does not take into account the incidence of taxes on the product - VAT/CST rates - 5.5% to 6.6%; excise duty 10% and Education Cess
6.	Revisit thresholds for SME's every 2 years Recommend Periodic review mechanism be institutionalized,	To ensure that the thresholds are revisited at predefined frequencies and suitably changed to be realistic and relevant with time

SOFTWARE PRODUCT TAXATION ISSUES

1. DUAL LEVIES ON SOFTWARE-VAT AND SERVICE TAX

Software can either be a customized software developed as per the specific requirements of the customer or a packaged software which is an “off-the-shelf” software available to be used by a number of users.

- The definition of the term “service” as per section 65B (44) is wide enough to cover any activity and excludes sale of goods and other deemed sale transactions as per Article 366(29A) of the Constitution, like for example transfer of right to use goods. Hence, all transactions which are treated as “sale” shall be outside the ambit of service tax.
- Historically, while packaged software has been treated as “goods”, customized software has been treated as “services”. Accordingly, packaged software has been subjected to Sales Tax, VAT, Customs Duty and Excise Duty (depending upon the exact nature of the transaction), customized software has been subjected to Service Tax.
- In cases when software / licenses are supplied electronically VAT and Service Tax are levied but there is no levy of Customs Duty or Excise Duty since the same does not qualify as “goods” for the purposes of Customs / Excise laws.

Issue

- Over the years there have been conflicting views on the applicability of VAT and/or Service tax on the software transactions particularly sale of software either electronically or through media. This has resulted in dual levies of VAT and Service Tax and has impacted the overall viability of business.
- Often, the customers / clients (including Government departments) deny the payment of dual taxes and insist on payment of either VAT or Service Tax. This results into an additional cost for the companies since the tax component cannot be passed on to end customer.
- As software products from India emerge, and companies develop a business model where services are also bundled with the product, this issue of duality will impair competitiveness. Many software SMEs, for lack of clarity are advised to pay both VAT and Service Tax to avoid penalties
- SMEs do not have the luxury of large teams and dedicated personnel. A key technology person is often required to spend substantial time with tax authorities. This increases the overall cost and burden for companies. SMEs are not in a position to litigate given the resource constraints, long time taken to settle such disputes and the fact that they would rather concentrate on their core product and business development

Recommendation

It is recommended that CBEC clarify the following

1. Provision of standard software, including license to use such software, whether electronically or on a media, should not be subject to dual levies, and in case VAT is applied, it would not be liable to Service tax.
2. Given the stand taken by the Central Government on the treatment of software supplied electronically, it may be clarified that service tax is applicable on sale of software which is downloaded electronically and Central Sales Tax is not applicable on the same if the transaction is interstate transaction.

3. For software transactions which involve both a product and associated services, the services component should be subject to service tax alone, and the product value should be subject to VAT only.

2. PENDING TDS REFUNDS – IMPACT OF 10% TDS ON SOFTWARE PAYMENTS

Issue

SMEs and start-up software companies are suffering TDS @ 10%, since their actual tax liability on profits is far lower than the TDS liability. Thus, the situation of refund of TDS arises. TDS refunds remain pending hence these companies face an uncertain tax environment that is blocking their working capital and leading to serious operational difficulties.

Promoters have to augment capital since SMEs and start-up companies face hurdles in getting loans even in the SME category because their asset base is low and technology is not considered as an asset that can offset risk.

The Government decision to notify 10% TDS for software transaction maybe in line with the profit margins of the large and well established service providers of the IT sector. However, there is a need to recognize the niche technology driven small enterprises, and acknowledge that the margins and cost structures of such companies are different.

Recommendation

- Government has notified lower TDS rates for certain payments like payment transfer of immovable property (1%) and contractual payments (2%). TDS rate for software companies should also be reduced in consultation with the Industry. Ideally, the sector would request the Government to consider completely exempting Indian software companies from TDS u/s 194J.
- Government may consider adjusting pending refunds to future TDS liability.
- Banks may consider offering loans to companies based on pending TDS refunds, as if it is a book debt.

3. INCREASE THRESHOLD LIMITS OF SECTION 194J OF THE INCOME TAX ACT, 1961

In terms of Section 194 J of the Act, TDS @ 10% is required to be deducted on payments made for acquisition of software when the amount exceeds Rs. 30,000 in a financial year.

Recommendation

This threshold limit is low, it is recommended that this amount be increased to Rs. 3.00 lakh in a financial year. Alternatively, the Board may share the criteria of setting the limits and we could share relevant data to update the limit.

4. CLARIFICATION ON REQUIREMENT TO DEDUCT TDS ON UPGRADE AND SUBSCRIPTIONS.

Software Ancillary Services such as AMC's, Upgrade Fees, Subscriptions, etc. which do not involve transfer of rights, or grant of license but involve only payments of consideration for services is "Royalty" for the purposes of Section 194J r/w 9(1)(iv) Explanation 2 of the Income Tax Act, 1961.

Recommendation

Clarification may be issued that AMC's, Upgrade Fees, Subscriptions, etc. which do not involve transfer of rights, or grant of license, but involve only payments of consideration for services is not "Royalty" for the purposes of Section 194J r/w 9(1)(iv) Explanation 2 of the Income Tax Act, 1961 and that such transaction are not liable for TDS u/s 194 J of the Income Tax Act, 1961.

5. INADEQUATE ABATEMENT FOR PACKAGED/CANNED SOFTWARE FOR PAYMENT OF EXCISE DUTY

Issue

Abatement of 15% is allowed from RSP to arrive at the value of Packaged Software or Canned Software, falling under CETH 8523 of CETA 1985 for payment of excise duty. This was notified in 2008. (Serial No 93A of Notification No 49/2008-CE (NT) dated 24.12.2008, for valuation under Section 4A of the CEA, 1944)

This notified abatement of 15% does not take into account the incidence of taxes on the product - VAT/CST rates ranging from 5.5% to 6.6%; Octroi/Entry Tax of 5.5% in State of Maharashtra; excise duty from 10% ad valorem and Education Cess.

The taxes on the product amount to ~22% of the RSP and the notified abatement of 15% is not adequate

Recommendation

The abatement of 15% allowed under the said notification be increased to 30%.

Packaged/Canned software products are sold through a multilayer dealer/distribution chain through which they are delivered to the ultimate consumer high trade discounts on MRP are offered.

6. REVISIT THRESHOLDS FOR SMES EVERY 2 YEARS

The IT Act in recognition of the compulsions and limitations of the SME and start-ups have notified several thresholds below which provisions are not applicable. Unfortunately, these are not revised and lose their relevance in the evolving business environment.

We request that a periodic review mechanism be institutionalized, which will ensure that the thresholds are revisited at predefined frequencies and suitably changed to be realistic and relevant with time.

SUMMARY - TRANSFER PRICING		
S. No	Issues and Recommendations	Justification
7.	POLICY	
7.1.	Use of Multiple Year Data Clarifications to permit use of multiple year data for comparability analysis	Single year data may not reflect business conditions, performance. Multiple year data useful to even out such fluctuations
7.2.	Use of Interquartile Range instead of Arithmetic Mean Current practice of arithmetic mean can give skewed results Recommended to amend regulations for allowing use of Interquartile Range	Better indicator of comparable prices as it is less sensitive to extreme values specially when distribution is skewed International practice
7.3.	5% tolerance band as standard deduction Be made prospectively if interquartile range method is allowed, else to allow 5% for standard deductions of tolerance band	Arithmetic mean gives rise to skewed results and therefore requires tolerance band
7.4.	Guidelines for certainty and consistency	
	Currently, there is substantial ambiguity in case of Headquarter and regional Headquarter cost allocations being rendered by the overseas affiliate to the Indian entity. Recommend issue of guidance related to Intercompany loans, Guarantee / Letter of comfort / Undertaking, Headquarter and regional Headquarter cost allocations, Adjustments for differences in functions and risks	in case of comparability adjustments there is a lot of ambiguity with regard to methodology, application, quantification etc.
7.5.	Enlarged scope of "international transaction" retrospectively Definition of intangibles should be rationalised as it is too broad; Recommend withdrawal of business restructuring transactions within the ambit of transfer pricing	Definition of intangibles open to interpretations and can lead to litigations Amendment is substantive and therefore should not be retrospective
7.6.	TP Documentation threshold No documentation requirements on threshold limit upto INR 10 million Recommend increase of threshold limit for the sector	Upward revision in monetary limit required as software transaction values have increased, requiring almost all companies to maintain onerous documentation
7.7.	Penalty Provisions Penalty provisions made more stringent-penalty @ 2% of value of international transaction due to failure to keep information and 2% for not furnishing the information, in addition to the regular penalty Recommend penalty be restricted to disputed tax, not linked to transaction value	Quantum of addition is disputable; therefore fixing penalty on the assessed income will increase burden and uncertainty of the taxpayer.

<p>7.8.</p>	<p>Domestic Transfer Pricing Ambiguity in the current provision and no monetary threshold for exemption</p> <p>Recommend clarifications issued e.g. TP provisions to apply to revenue expense only; Definition of “close connection”; Increase monetary threshold limit</p>	<p>If not clarified, likely to create hardships for small scale businesses</p>
<p>7.9.</p>	<p>Change in Dispute Resolution Panel Structural changes required for more effective DRP</p> <p>Recommend DRP to be constituted as an ‘independent’ judicial board with panelists from economic legal and accounting background and tax department;</p>	<p>DRP has been limited in its ability to resolve disputes in the past and there have been prolonged litigations.</p>
<p>7.10.</p>	<p>Absence of Article 9(2) in DTAA's restricting bilateral APAs and MAP Indian tax authority disallow entering of bilateral APA's and MAP in case an Indian entity has an associated enterprise in countries wherein India does not have Article 9(2) in its DTAA's.</p> <p>Recommendation Need for deliberation and industry consultation. Government should advise companies on how to address the challenges arising due to absence of certain provisions in the tax treaties</p>	<p>Issues in claiming benefits of DTAA</p>
<p>7.11.</p>	<p>Roll back for APAs an application for APA, once agreed upon is prospective in the sense that they are applicable for the years agreed upon in the agreement</p> <p>Recommend once an APA is finalized, the tax payer should be allowed to close the open years for which assessment proceedings have not yet been initiated and years for which assessment or appeal proceedings are pending before the TPO, DRP/CIT (A), having regard to the agreement reached in the APA.</p>	<p>This will help in reducing the hardship to the taxpayers through expeditious resolution of cases.</p>
<p>8.</p>	<p>Safe Harbour Rules and its impact on assessments Safe harbour notifications have had limited uptake. As apprehended by the industry, the Safe Harbour rules as notified in September 2013 are having an impact on the overall assessments for AY 2010-11 in the classification of services as software or ITeS and also in arriving the arm's length margins</p> <p>Recommend that safe harbour notification needs to be re-examined for margins to be rationalized, to address overlap between R&D and software development</p>	<p>Limited adoption and not reflecting business realities</p>

9.	<p>Levy of penalty on single transaction to be rationalized Multiple provisions for levy on penalty on a single transaction</p> <p>Recommend that a single penalty be levied on non-compliance of a provision to avoid duplication of penalty.</p>	<ul style="list-style-type: none"> • Section 271AA: Failure to keep and maintain information, documents; • Section 271 BA: Penalty to furnish report from accountant; • Section 271 G: Penalty for failure to furnish information u/s 92D
10.	<p>Non processing of refunds when notice issued u/s 143(2) a return under section 143(1) of the Act shall not be necessary, where a notice has been issued under section 143(2) of the Act</p> <p>Recommend that this clause should be deleted.</p>	<p>Excess taxes if any paid over the final tax liability by any entity gets stuck for ~ five financial years. In case the final assessment order is high or there is an undue demand, assesseees are required to pay further taxes without getting the refund originally due.</p>
11.	<p>TRANSFER PRICING – PROCEDURAL ISSUES</p>	
11.1.	<p>Objective Criteria for Identifying Comparables Disputes arising out of difference in choice of comparables increasing. Recommend functional and risk profile be taken into account to determine ALP.</p>	<p>Functionally dissimilar companies should not be chosen as comparables. Data and information from public companies’ databases should be further validated from annual reports in the public domain.</p>
11.2. 11.3.	<p>Adjustments for risk, working capital and others, clarity on operating and non-operating items Lack of adjustments for different risk profile, inconsistency in allowing working capital adjustment in spite of it being endorsed by the ITAT in its judgments. Recommend suitable adjustments be factored while determining arm’s length price and a standard approach classifying operating / non-operating items be prescribed to remove any ambiguity.</p>	<p>Standard methods remove ambiguity and should be considered for working capital, risk adjustments. Accounting consistency to eliminate differences that may arise from differing accounting practices between the controlled and uncontrolled transactions, differences in capacity utilization, start up costs,</p>
11.4.	<p>Advertising and Marketing Expenses TP adjustments are made on advertisement and marketing expenditure linking them to marketing intangibles. Recommend appropriate guidelines to clarify that selling expenditure incurred does not create an intangible as a service to the associated enterprise. For advertisement and marketing expenditure incurred in connection with products sold/ to be sold in India, there should not be any inference of a service.</p>	<p>Every expenditure incurred towards advertisement and marketing does not lead to intangibles.</p>

TRANSFER PRICING ISSUES

Transfer pricing involves substantial exercise of judgment with regard to (i) selection of comparables, (ii) inclusion / exclusion of items of income and expenditure for establishing a comparable base and (iii) risk adjustments to be made. Significant differences in exercise of judgment are vitiating the objective of determining the arm's length price. The Transfer Pricing Officers have to contend with an overwhelming volume of records and documents maintained and produced by the assesses and yet it appears that these get to be regarded as extraneous in the determination of the arm's length price in TP assessments.

There is a need to amend current Transfer Pricing policy to incorporate the following for globally harmonized and reliable assessments.

7. POLICY

7.1 Use of Multiple Year Data

Issue

Current Indian TP regulations, Rule 10B (4) of the Income tax Rules 1962 (Rules) provide for use of data of the financial year in which the international transaction has been entered into. It further permits use of multiple year data (period not being more than two years prior to such financial year), if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared. The taxpayers need to have their transfer pricing analysis in place at the latest by the due date of filing their income-tax return.

Multiple year data is useful to even out the fluctuations caused by business, economic and product life cycle

Single year data may not adequately reflect the business conditions, performance of the taxpayer but the Revenue authorities reject the use of multiple year data and adopt the data of the relevant financial year only. Further, from the taxpayer's point of view if relevant data is not available in the public databases at the time when the benchmarking exercise is undertaken, then there is sufficient reason for multiple/prior year data to be accepted.

The use of multiple year data is also supported by the transfer pricing regulations / practices in various overseas jurisdictions like US, Australia, etc.

Our analysis of margins for the year FY 2011-12 for a set a comparables for IT companies and ITeS companies reveal that there may be instances where the variation in the single year and multiple year data are not significant. However, the same is subject to the nature of the available data. For examples, after applying various qualitative and quantitative filters for a set of comparables, the variation in the margins for IT comparables was not much while for ITeS it was significant. Please refer to **Annexure 1** for further details.

Recommendation

Relevant clarifications should be incorporated in the regulations that clearly permit use of multiple year data for comparability analysis.

7.2 Use of Interquartile Range instead of Arithmetic Mean

Issue

Indian transfer pricing regulations stipule an arithmetic mean of the margins of all comparables to determine the arm's length margin in case more than one comparable is identified. Arithmetic mean of margins leads to a skewed determination of arm's length margins as it is influenced by outliers. While median is acceptable globally, inter-quartile range is also used in many countries (such as US,

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UK, Australia, etc.) as the outcome is less sensitive to extremes in the sample (particularly where the distribution is highly skewed) and the result gives a more scientific interpretation of the data points.

Recommendation

The TP regulations be amended to permit application of the concept of an arm's-length range of prices, similar to provisions contained in the OECD regulations or allow use of inter quartile range as those of other developed nations, instead of making transfer pricing more restrictive it needs to reflect market realities.

7.3 Tolerance band as standard deduction

Issue

The Finance Act 2012 inserted sub-section (2A) to section 92C captioned "computation of arm's length price" with effect from the 1st day of April, 2002. The sub-section clarifies that the benefit of 5 % is not a standard deduction and overturns the laws as interpreted by various Tribunals.

Recently, Government has made an amendment to the tolerance band notifying¹ that the price at which the international transaction or specified domestic transaction has actually been undertaken, shall be deemed to be at ALP, if the transaction price:

- does not exceed one per cent, in case of wholesale traders; and
- Does not exceed three per cent, in all other cases.

Recommendation

Since the law requires the arm's length price to be the arithmetical mean and does not prescribe inter quartile range which is a globally accepted best practice, the provision of tolerance band as standard deduction be retained.

7.4 Guidelines for certainty and consistency

Issue

Currently, there is substantial ambiguity in case of Headquarter and regional Headquarter cost allocations being rendered by the overseas affiliate to the Indian entity. Further, in case of comparability adjustments there is a lot of ambiguity with regard to methodology, application, quantification etc.

This can be substantially reduced if the Board issues appropriate guidelines giving due consideration for the factors involved.

Recommendation

Guidelines can be issued by the Board giving due consideration for the following factors:

7.4.1 Inter-company Loans

- i. Intention for advancing of interest free loans, especially in case of 'quasi-equity'. A loan which is 'quasi-equity' should be regarded as equity and there should not be requirement for charging interest on such loans.
- ii. Role of lender of loan especially when loans are rendered under parental role / shareholder's activity. If the loans are provided out of surpluses of the Indian parent and they are supporting the parental role / shareholder's activity, there should not be requirement for charging interest on such loans.

¹ Notification No. 30/2013 dated 15 April 2013 issued by the Government, to be applicable for Assessment Year 2013-14 (Financial year 2012-13)



- iii. Commercial reasons and inherent business benefits in terms of enhanced business
- iv. Global practices for benchmarking interest rates to be charged, if any, by considering comparable interest rates prevailing in the borrower's country (e.g. LIBOR for loans given from India to European AEs)

7.4.2 Guarantee / Letter of comfort / Undertaking:

- i. Business rationale in terms of future benefit received by the company providing guarantee
- ii. The association of the parent company for securing contracts as a group should not be construed as resulting in international transactions between the Indian Company and the overseas subsidiary;
- iii. Arm's length price, if computed, should be on the basis that benefits to be secured are reduced from the price of such assurances in comparable uncontrolled transactions.

7.4.3 Headquarter and regional Headquarter cost allocations:

- i. Absence of industry benchmarks in public domain to test management payouts.
- ii. Guidance on specific documentation to be maintained elaborating costs incurred and the benefits received.

7.4.4 Adjustments for differences in functions and risks

- i. Clear guidelines on carrying out economic and risk adjustments with proper methodology.
- ii. Revenue authorities to give due consideration to business strategies and commercial realities such as market entry strategies, market penetration, and non-recovery of initial set-up costs, unfavourable economic conditions and other legitimate business peculiarities while determining the arm's length pricing

7.4.5 Restructuring

A comprehensive guidance or definition on what types transactions will be covered under restructuring or reorganizing (such as conversions and transfers that have cross-border impact) and the detailed reporting and benchmarking requirement be specifically laid down.

Section 92B considers a transaction of business restructuring or reorganization as an international transaction. However, there is no definition of restructuring or reorganization in the Act. Accordingly, there exist an ambiguity as to what transactions gest covered under business restructuring or reorganization. In addition, there is no clarity as to whether a transaction of business restructuring or reorganization would need to be reported if the act of business restructuring results in the enterprises becoming an AE.

7.4.6 Corporate actions - Issue of shares, Buyback / Redemption

Historically, the view has been that transactions such as issue, buyback and redemption of shares are capital transactions and hence not considered for the purpose of income tax levy, except in the case of capital gains arising out of these transactions. In this context, issue and redemption of shares are corporate actions which are initiated by the shareholders of the company.

However, in the recent past, in the course of transfer pricing assessment proceedings, the Revenue has been taking the stand that they are covered within the ambit of international transaction and hence needs to be documented and benchmarked. Hence there exist considerable ambiguity in considering these corporate actions (which are capital in nature) within the ambit of transfer pricing when there is no basis of charge in the first place.

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In addition, by applying transfer pricing provisions to corporate actions, transactions such as issue of bonus shares (ratio of bonus issue), and rate of dividend declared, or discount/premium on issue or redemption of preference shares etc. may also get covered within the purview of transfer pricing provisions. Fundamentally, transfer pricing provisions being machinery sections, cannot extend to transactions that are basically not liable to tax.

Recommendation

There is a need for guidance on the rationale of applying transfer pricing provisions to capital transactions and corporate actions such issue, buy back and redemption of shares to the extent these transactions don't have a bearing on the taxable income of the entity.

Further, guidance is required on what are the terms and conditions to be complied with in instances of issue, buyback or redemption of share to mitigate the exposure to transfer pricing litigation on this count.

7.5 Enlarged scope of “international transaction” retrospectively

Issue

- (i) Definition of “intangible property”, amongst others, to include marketing channel, brand, exterior design, data processing related intangibles, automated databases, integrated circuit masks and masters, customer list and relationship, contract related assets like favourable suppliers, contracts, trained and organized workforce, employment agreements, methods, programmes, campaigns, surveys, forecasts, estimates, any other similar item that derives its value from its intellectual content rather than its physical attributes.
- (ii) Business restructuring or reorganization, irrespective of whether it has any bearing on profit, income, losses, or assets,
- (iii) Guarantees, credit period on outstanding loans (business debts).

Recommendation

- (i) The intent behind transfer pricing regulation is to curb tax avoidance and hence provision to bring the business restructuring transactions within the transfer pricing ambit should be withdrawn.
- (ii) The definition of intangibles being too broad and open for interpretation needs to be rationalized. Further, guidance should be issued to recognize certain methodologies/approaches to evaluate the arm's length nature of intangibles.
- (iii) Given the increasing quantum of cross border financing and inter-company lending etc., appropriate guidance should be issued in this regard.
- (iv) Further, the amendment, being substantive in nature, shall be made prospective to achieve certainty and stability.

7.6 TP Documentation threshold

Issue

For aggregate value of transactions exceeding INR 10 million, TP documentation is required.

This monetary threshold prescribed for TP documentation has not been changed since the introduction of TP Regulations in the Income-tax Act, 1961. Further, given the ever increasing quantum of cross-border transactions, the prescribed limit seems to be on the lower side especially in case of software companies as software transaction values have increased manifold, requiring almost all companies in this sector to maintain onerous documentation.

Recommendation

Upward revision in monetary limit is required as software transaction values have increased, requiring almost all companies to maintain onerous documentation.

7.7 Penalty provisions

Issue

Penalty provisions have been made more stringent vide Finance Act 2012. Transfer Pricing Officer can now ask the taxpayer to pay penalty under section 271AA at the rate of 2 per cent of value of international transaction due to failure to keep information in addition to another 2 per cent under section 271G for not furnishing the information besides regular penalty under section 271(1)(c) of the Act. While the quantum of addition itself is disputable in transfer pricing assessments, fixing the penalty on the assessed income would increase the burden of the taxpayer considerably.

Recommendation

Penalty should be restricted to tax in dispute and not linked to the value of transaction.

7.8 Domestic Transfer Pricing

Issue

Section 92BA has been inserted vide Finance Act 2012 by which the coverage of transfer pricing has been expanded to include certain 'Specified Domestic Transactions' if the aggregate amount of all such transactions entered by the assessee in the previous year exceeds Rs. 5 crores in the previous year.

- The term 'Specified Domestic Transactions' has a very wide coverage and a relatively low monetary threshold for exemption.
- The term "specified domestic transaction" includes any expenditure in respect of which payment has been made or is to be made to a person referred to in clause (b) of sub-section (2) of section 40A of the Act. Such expenditure could possibly include capital expenditure made to such a related person. It should therefore be clarified that these provisions pertain to revenue expenditure only.
- This amendment also covers a scenario wherein the payment of remuneration by the company to its director or relative of such directors is also required to be at arm's length. The same casts an onerous responsibility on the company vis - à - vis justification of the arm's length nature of such payments.
- Further, there is ambiguity in relation to the definition of the term 'closely connected persons' as described in section 80IA (10) of the Act, a suitable clarification should be provided in this regards.

Recommendation

- (i) It is recommended that the threshold limit for applicability of transfer pricing regulations to specified domestic transactions be increased from Rs. 5 crores to Rs. 15 crores to avoid undue hardship for small businesses
- (ii) Necessary guidance for benchmarking directors' remuneration should be provided, as by the nature itself these could be very peculiar transactions depending on the extent of ownership, technical ability, seniority etc.

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- (iii) The amendment relating to domestic transfer pricing provisions applicable to all those companies considered as related parties under section 40A(2)(b) of the Act seeks to cover a situation wherein there could not be any loss to the exchequer. The same is not in line with the suggestion provided by the Supreme Court in case of Glaxo SmithKline. The Supreme Court had provided the situation wherein transfer pricing should be applicable in case of transactions between a profit making and a loss unit / company. The other scenario which was envisaged by the Supreme Court was transactions between units / assesses having different tax rates. Other than the scenarios contemplated above, a corresponding adjustment should be allowed and hence provided for on the statute.
- (iv) It should be suitably clarified that the transfer pricing provisions would only apply to revenue expenditure referred to in section 40A(2)(a) of the Act, and not to all payments made to persons specified in section 40A(2)(b) of the Act.
- (v) The words “close connection” appearing in section 80-IA(10) of the Act needs to be clarified to avoid ambiguity in the application of provisions of section 92BA of the Act.
- (vi) Further, clarity should be provided with regard to inter-unit allocation of costs between eligible and non-eligible units i.e. whether corporate cost allocations from a non-tax holiday unit of a company to a tax holiday unit of the same company would get covered within the provisions of Section 80-IA(8) and consequently need to be reported as a specified domestic transaction.
- (vii) The Advance Pricing Agreement (APA) provisions are being made applicable to only international transactions. The same should also be made applicable to domestic transactions covered by transfer pricing regulations.

7.9 Changes in Dispute Resolution Panel

Section 144C was introduced w.e.f. 1-4-2009 and deals with reference to DRP as a pre-assessment statutory requirement. With Section 144C providing that the DRP shall be constituted by the Board as a collegium three Commissioners of Income-tax, a statutory framework is provided for senior officials to take objective decisions. Section 253 is amended w.e.f. 1-7-2012 to provide that the directions issued by the DRP u/s 144C(5) is appealable before the ITAT. The over-arching objective of making a referring the draft assessment order to the DRP is to resolve the disputes and arrive at finality.

Issue

- a) Though the right of appeal to the ITAT is provided for objections filed on or after 1st July 2012, the DRP is still not serving its central purpose i.e. dispute resolution. The DRP directions for objections filed after July 1, 2012 also tend to follow the earlier DRP directions, which were issued when there was no right of appeal.
- b) The DRP issues directions with the stated objective of keeping the issues alive since the Revenue has filed appeals before the High Court / Supreme Court. This is contrary to the objective of dispute resolution.
- c) The DRP is structurally suffering from impaired independence owing to the fact that the DRP is a constitution of CIT/DIT.
- d) The CIT/DIT have been discharging their duties/ functions of DRP in addition to their regular duties, and are accordingly constrained. Thus, the important task of resolving disputes of assessee receives only a divided attention.

Recommendation

- DRP should be constituted as an ‘independent’ judicial board, much like the Approving Panel for Advance Pricing Agreements. Rather than comprising of only revenue officials who are duty-

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bound to meet revenue collection targets, the DRP should have panelists from economic, legal or accounting background and with knowledge of income tax matters.

- In order to avoid cases of actual or perceived bias and to ensure objectivity in the dealing of cases, specific provisions may be inserted to restrain a jurisdictional Commissioner/ Director from being appointed as a member of the DRP hearing cases falling within his/ her jurisdiction. This view was also endorsed by the recent judgments².
- Constitution of a legal cell to monitor progress of tax cases and
- Suo-moto withdrawal of cases which are covered by decisions of courts and which are found without merit.

7.10 Absence of Article 9(2) in DTAs restricting bilateral APAs and MAP

Issue

India does not have Article 9(2) in its DTAs with certain major trading partners including Belgium, Germany, France, Singapore and the Republic of Korea. In the absence of Article 9(2), The Competent Authority of India has so far followed the practice of not admitting cases of economic double taxation under its MAP and as per the guidance note, the tax administration would apply similar position to the APA program.

Pursuant to the same, Indian tax authority disallow negotiation of bilateral APA's in case an Indian entity having an associated enterprise in such countries. Mutual agreement procedures (MAP) negotiations are also disallowed in such countries.

Further, the OECD commentary provides even if a bilateral tax treaty does not contain the provisions of corresponding adjustment in TP matters, in the form of Article 9(2), the two sovereign States can still mitigate double taxation arising out of TP adjustments by allowing corresponding adjustments, through invoking Article 25(3). In this regard too, India, (which has the status of an observer nation to the OECD MC of 2010), has reservations with the mechanism of granting corresponding adjustment in TP matters through invoking Article 25(3).

Indian views are driven from the understanding that OECD Model Tax Conventions do not represent internationally agreed guidance and have suggested that an Inter-Governmental Commission with a balanced representation from the Governments of developing and developed countries should be construed to take decisions with regard to these provisions.

Recommendation

There is a need for deliberation and industry consultation in this regard and Government should advise companies on how to address the challenges arising due to absence of certain provisions in the tax treaties. This would also ensure a continuing trade relation with important trade partners of India, namely Singapore, Germany, France, and the Republic of Korea.

7.11 Roll back for APAs

Issue

Currently an application for APA, once agreed upon is prospective in the sense that they are applicable for the years agreed upon in the agreement.

² *Hyundai Heavy Industries [2011-T11-28-HC-UKHAND-INTL]*
Huntsman International (India) Limited 23 taxman.com 52 (Mum)
Lionbridge Technologies Private Limited [2012] 51 SOT 40 (Mum)

Recommendation

It is recommended that once an APA is finalized, the tax payer should be allowed to close the open years for which assessment proceedings have not yet been initiated and years for which assessment or appeal proceedings are pending before the TPO, DRP/CIT (A), having regard to the agreement reached in the APA. This will help in reducing the hardship to the taxpayers through expeditious resolution of cases.

8. Safe Harbour Rules and its impact on assessments

The Indian IT Industry has been facing several unwarranted assessments on account of transfer pricing adjustments. While the APA program has taken off, and companies are considering adoption, the Safe harbour notifications have had limited uptake. As apprehended by the industry, the Safe Harbour rules as notified in September 2013 are having an impact on the overall assessments for AY 2010-11. The impact is seen in the classification of services as software or ITeS and also in arriving the arm's length margins.

- Categorization – Assessing officers are using the sub-categories as detailed in Safe Harbour rules (BPO, KPO, R&D< contract R&D) as a framework to categorize companies in several jurisdiction. The Industry was apprehensive that such efforts will result in high margins and there is no comparable data available
- Margins – In several assessments, Safe Harbours margins have been used as a floor rather than the outside limit in determining the arm's length margin (ref table)

Assessment Year	Mark-up for IT companies	Mark-up for ITeS companies	Mark-up for IT determined by Revenue	Mark-up for ITeS determined by revenue
2006-07	10 to 15 %	10 to 15 %	23 to 25 %	25 to 28 %
2007-08	10 to 15 %	10 to 15 %	23 to 27 %	29 to 31 %
2008-09	13 to 18 %	13 to 18 %	23 to 27 %	28 to 31 %
2009-10	13 to 18 %	13 to 18 %	23 to 29 %	28 to 34 %
2010-11	5 to 20 %	6 to 18%	20 to 29 %	23 to 36 %

- Criteria for Identifying comparables and filters adopted

Tax authorities continue to pose problems by adopting different criteria of selecting comparables for benchmarking. Functional, assets, risk profile and the prevailing business conditions are not being considered appropriately for e.g. the marketing set employed by the tax authorities seemed to revert more towards commission agents, insurance and broking sets as was utilized 2 years ago in spite of the tribunal having rejected commission companies while identifying comparable companies.

Filters adopted by the authorities across jurisdictions are ignoring business conditions. For e.g., companies earning supernormal profits (margins 50% to 80%) and industry giants are used as comparables. Companies with declining sales for the last 3 years are being rejected as comparables despite taxpayers excluding companies with continuous losses in last 3 years in their comparator set.

- Recent rulings / DRP decisions overlooked

Recent rulings and judgments passed in favour of the taxpayers overlooked e.g. Adjustments made on outstanding inter-company receivables despite ITAT judgments supporting the fact that no such adjustments are warranted. Imposition of cap on working capital, continued use of very high turnover companies in marketing sets where tribunal orders are not being regarded.

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We therefore recommend that safe harbour notification needs to be re-examined, the following recommendations maybe considered in this regard.

8.1 Margins to be rationalized

Issue

Currently, the margins notified under the safe harbour vary from 20 to 30 percent depending on the characterization of the entity. The margins are high and not reflective of the business realities. Hence, very few companies in the IT sector have opted for the safe harbours.

We believe that the current safe harbour margin have been determined on the basis of the margins determined by the Revenue authorities in transfer pricing audits. And that tax payers' propositions and rationalization of margins by higher appellate authorities (through elimination of outliers and functionally different companies) have not been considered in arriving at the safe harbour. Therefore the current safe harbour do not reflect the arms' length price.

Recommendation

It is recommended that more practical and feasible margins, that are reflective of the ALP be notified under the safe harbour rules, especially after taking into account the rationalization of margins by the higher appellant authority. The intention is to make the Safe Harbour scheme as appealing, if no more, than APA, because at the moment, there are several takers for APA (approx. 370), whereas there are only a handful of applications for SH. This imbalance needs to be quickly rectified, especially for small and medium enterprises, because it would put unnecessary pressure on the APA system if it is always the preferred route.

8.2 Overlaps between R&D and Software Development

In the prevalent safe harbour rules, software development is a separate category with a safe harbour of 20 percent and contract R&D with insignificant risk is another category with safe harbour of 30 percent. However, there exist very fine line of distinction between contract R&D and software development. The definition of Software Development services and Contract R&D services in Safe Harbour rules is ambiguous are subject to the interpretation and understanding of the AO.

- There can be substantial overlap in the activities.
- It is difficult to bifurcate the software development work done based on the components of the two definitions.
- Such classifications can be highly subjective e.g. a service as research and development versus software development / information technology enabled service / knowledge process outsourcing service.

Some specific examples

- Debugging of systems is an integral part of "testing" phase of software development and therefore would be all pervasive in most of the definitions in Contract R&D.
- Introducing new user features in any application that enhance "business intelligence" by presenting data in various analysis-friendly formats is no different from "software development that advances storing, retrieving, manipulation or display of information". Such user features may be standard built into the application, or may have to be customized/adapted.
- Software development requires coding and testing tools. Often, new coding and testing tools are also developed using existing coding and testing tools. These tools are standard products and used by a variety of companies – classifying as business

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application software – yet would also be considered “development of software development tools” for purposes of contract R&D.

- There can be a very thin dividing line (if any) between “Engineering and Design” services (identified as knowledge process outsourcing service) and research and development services relating to “Engineering & Design”. Example, modification of engineering drawings and designs for products and processes using research processes involving computers and computer enabled equipment – is that R&D or Engineering and Design?

Recommendations

Due to the exclusion of research and development from software development, information technology enabled services and knowledge process outsourcing services in the draft rules, new litigation on the classification of such service providers would arise. Hence it is recommended that both the categories be merged and a new safe harbour be notified keeping in mind the recommendation in the point above.

9. LEVY OF PENALTY ON SINGLE TRANSACTION TO BE RATIONALIZED

Issue

Currently, there are multiple provisions for levy on penalty on a single transaction. Accordingly, in the Act, there are penalties for the following:

- Section 271AA: Failure to keep and maintain information and documents;
- Section 271 BA: Penalty to furnish report from accountant; and
- Section 271 G: Penalty for failure to furnish information or document under section 92D.
- The same results in multiple penalty being levied for the same default or non-compliance.

Recommendation

Penalty provisions are implemented with the intention to get the tax payer to adhere to the provisions of the Act rather than cause considerable hardship. Accordingly, it is recommended that a single penalty be levied on non-compliance of a provision to avoid duplication of penalty. For e.g., Section 271AA imposes 2 percent penalty on transaction value in the event of failure to keep and maintain information and documents under section 92D. Section 271G again imposes 2 percent penalty on failure to furnish the information or documents maintained under section 92D. In the event that a tax payer has not maintained the documents, such taxpayer should be penalized only under section 271AA and not under both section 271 AA and section 271 G.

Further, penalty should not be imposed for non-reporting of transactions which gets covered under the purview of international transaction by virtue of retrospective amendments, due to impossibility of performance.

10. NON PROCESSING OF REFUNDS WHEN NOTICE ISSUED U/S 143(2)

The Finance Act 2012 has inserted clause 1(D) to section 143 of the Act, specifying that the processing of a return under section 143(1) of the Act shall not be necessary, where a notice has been issued under section 143(2) of the Act. Though the language of the aforesaid provision suggests that it is directory and not mandatory in nature, however it has been observed that the Tax Office is not processing any refunds under section 143(1) because of this provision.

Further in case of the aforesaid entities a draft assessment order is passed and typically it takes almost one year more to get the final assessment order.

Following the above, excess taxes if any paid over the final tax liability by any entity gets stuck for ~ five financial years. In case the final assessment order is high or there is an undue demand, assessee

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are required to pay further taxes without getting the refund originally due. This is causing undue hardship to assesseees.

Recommendation

It is pertinent to note here that a time limit of four years from the end of the financial year has been prescribed for the completion of assessment of entities to which transfer pricing provision applies. Therefore it is here by recommended that this clause should be deleted.

Further this could cause undue pressure on the Revenue arising out of interest liability for a longer period.

11. PROCEDURAL ISSUES

Revision of comparables by tax authorities at the time of assessment had led to uncertainty and TP assessment has become a mathematical exercise to reach a higher average profit margin of comparable companies by using outliers. The over aggression of tax authorities has left all concerned. In the Indian context, IT and ITES service providers have had tax holidays and hence, there was no incentive for any of the players to under-report income in India since reporting higher income would not have caused any tax outgo. Transfer pricing is not used by most taxpayers to evade taxes. The other transacting entity (the one paying the Indian service provider) is usually tax-paying and pays tax at a rate between 28% to 35%.

Issue

- (i) Disputes and litigations arising out of difference in choice of comparables e.g. comparing software product companies (companies owning their own software products) with software service companies, comparing companies with turnover multiple times of that of the tested party (entity whose margins are being benchmarked)
- (ii) Lack of adjustments for different functional/risk profile, inconsistency in allowing working capital adjustment in spite of it being endorsed by the Indian Income Tax Appellate Tribunal in its various judgments.
- (iii) Ineffective Controversy Resolution: Companies face frequent disputes relating to transfer pricing, further compounded by an effective dispute resolution mechanism. Most assesseees' use the litigation channel for dispute resolution. Globally, TP disputes are resolved through a settlement mechanism between the tax authorities and the taxpayer. However, in India, the initiatives for controversy resolution mechanism are inadequate, primarily due to implementation issues.

Recommendations

11.1 Objective Criteria for Identifying Comparables

Functional profile and risk profile of the tax payer should be taken into account to determine Arm's Length Pricing. The benchmarking process adopted by the tax authorities should be objective.

- (a) Publishers of databases have wholly different criteria for classification of companies. Such published data and information extracted databases should be further validated / verified from published annual reports available in the public domain.
- (b) Unaudited information should not be relied upon.
- (c) Functionally dissimilar companies should not be chosen as comparables.
- (d) Loss making comparables are excluded without proper reason and super normal profit comparables are included by the Revenue authorities which results in higher mean mark-up of the comparables. Proper reasons should be attributed to each comparable being excluded.

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- (e) Comparables selected by the Revenue authorities often have significant intangibles unlike captive offshore entities

11.2 Adjustments for risk, working capital and others

Suitable adjustments need to be factored while determining the arm's length price. The following type of comparability adjustments should be prescribed.

- a) **Working Capital Adjustment:** OECD prescribed formula offers a standard method and removes ambiguity maybe considered for working capital adjustments
- b) **Risk adjustment:** Most comparables selected by the Transfer Pricing Officers are ex-facie independent companies, which inherently undertake all risks. Given the basic economic principle that higher risks potentially lead to higher profits, an adjustment needs to be made to margins of such companies selected as comparables. A Circular may be issued specifying the margins for typical type of risks assumed by independent companies. For example, it could be clarified that (i) standard margins for marketing and sales related activities is 8% of the sales price; (ii) standard credit period will be reckoned as 30 days and if the credit period extended in international transactions is more than 30 days, the price should be enhanced @ 12% per annum; (iii) standard margin for assuming credit risks is 6% of the sale price (comparable to discount for assignment of good quality book debts without recourse). The Transfer Pricing Officers will be required to make these standard adjustments for arriving at the arm's length price.
- c) **Other adjustments:** Other comparability adjustments include adjustments for accounting consistency designed to eliminate differences that may arise from differing accounting practices between the controlled and uncontrolled transactions, differences in capacity utilization, start up costs, these should also be considered.

11.3 Clarity on operating and non-operating items

Tax authorities and taxpayers have followed a different approach in classifying certain items as operating and non-operating hence ensuing litigation. However, the Safe Harbour rules 2013 have listed inclusions in operating revenues and operating expense. This maybe considered to be a standard approach for adoption during assessments.

Recommendation

A standard approach for classifying operating and non-operating items should be prescribed by tax authorities in general for all taxpayers which could be in line with the Safe Harbour Rules to remove any ambiguity.

11.4 Advertisement and Marketing Expenditure

Issue

The transfer pricing officers are increasingly issuing notices on advertisement and marketing expenditure of assessee's contending that such expenditure is leading to creation of marketing intangibles and it is in the nature of service, irrespective of the nature of business/expenditure.

International companies establish operating subsidiaries in India with a view to sell the products in India. The Indian entity would incur selling expenses including in the nature of advertisement and sales promotion expenses. The amount of expenditure incurred would depend on factors such as the competition in the business, the business targets, creating the requisite awareness on the products amongst the potential customers, company marketing strategy etc.

Recommendation

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There should not be any inference that selling expenditure incurred creates an intangible as a service to the associated enterprise. So long as the advertisement and marketing expenditure incurred are in connection with products sold/ to be sold in India, there should not be any inference of a service being rendered by the Indian entity to its associated enterprise. This principle should be followed even if there is an incidental benefit. Appropriate instructions / guidelines should be issued to the transfer pricing officers in this regard.

ANNEXURE II:

Search for Comparable Companies for ABC India (IT)

The objective of search for comparable companies was to identify a group of independent companies with publicly available data that perform broadly similar functions (i.e., software development services), operate in broadly similar markets, and bear risks broadly similar to that of ABC India.

The data is collected from annual / quarterly results, government reports and other sources.

Searched for companies in the databases having either same 'Economic activity' and / or 'Products / Raw materials' as that of the tested party (ABC India).

Filters applied:

1. Companies for which financial data was either not available or available only up to March 2009 databases
2. Companies having zero sales or sales less than Rs. One crore in the latest year for which the financial data was available in the databases
3. Companies disclosing segmental data but whose service segments appeared to be unrelated / different from that of ABC India and companies excluded for other reasons (based on information contained in the product profile, Directors' Report, and other information available in the databases)
4. Companies whose manufacturing sales were equal to or greater than 50% of their total sales in the latest year for which the financial data was available in the databases
5. Companies whose trading sales were equal to or greater than 50% of their total sales in the latest year for which the financial data was available in the databases
6. Companies whose services appeared to be different from that of ABC India and companies excluded for other reasons (based on information contained in the product profile, Directors' Report, and other information available in the databases).

A qualitative review of the companies was conducted companies whose services appeared to be different from that of ABC India.

1. Companies where the income from foreign exchange was less than 25% of the total income were excluded.
2. Also, companies having an employee cost of less than 25% of their total cost were excluded.

NASSCOM®**Arm's Length Range**

The final set along with the weighted average NCPs using three year financial data i.e. of FYs 2009-10, 2010-11 and 2011-12 (to the extent available) are listed below:

Sr. No.	Name of the Company	NCP 2009-10 (%)	NCP 2010-11 (%)	NCP 2011-12 (%)	Weighted Average
1	Akshay Software Technologies Ltd	(3.19)	0.66	9.87	2.93
2	Evoke Technologies Pvt Ltd	18.72	8.33	NA	12.55
3	E-Zest Solutions Ltd.	18.14	41.85	NA	29.57
4	Goldstone Technologies Ltd	3.01	5.92	11.01	6.62
5	Mindtree Ltd	22.98	9.06	14.43	14.81
6	Persistent Systems Ltd	30.53	25.87	27.09	27.57
7	R S Software (India) Ltd	9.88	16.35	15.28	14.09
8	R Systems International Ltd	18.62	6.50	2.60	8.90
9	Sasken Communication Technologies Ltd	24.71	27.03	17.00	22.79
10	Tata Elxsi Ltd	17.13	8.59	6.55	10.11
11	Thirdware Solutions Ltd.	29.59	17.45	NA	22.74
12	Vama Industries Ltd	9.33	14.59	27.52	15.47
	Arithmetical Mean	16.62	15.18	14.59	15.68

NCPs of the Comparable Companies –Multiple year

NA - Not Available

On the basis of the above, weighted average NCPs of broadly comparable companies range from 2.93% to 29.57% with an arithmetical mean of **15.68 %**.

Sr. No.	Name of the Company	NCP 2011-12 (%)
1	Akshay Software Technologies Ltd	9.87
2	Evoke Technologies Pvt Ltd	11.61
3	E-Zest Solutions Ltd.	18.79
4	Goldstone Technologies Ltd	11.01
5	Mindtree Ltd **	14.43
6	Persistent Systems Ltd	27.09
7	R S Software (India) Ltd	15.28
8	R Systems International Ltd *	2.60
9	Sasken Communication Technologies Ltd **	17.00
10	Tata Elxsi Ltd *	11.28
11	Thirdware Solutions Ltd.	19.63
12	Vama Industries Ltd*	31.07
	Arithmetical Mean	14.42

NCPs of the Comparable Companies for IT (FY 2011-12) – Single year

* Segmental Companies; ** Segmental companies computed at an Entity Level

NASSCOM®**Search for Comparable Companies for ABC India (ITeS)**

The objective of search for comparable companies was to identify a group of independent companies with publicly available data that perform broadly similar functions (i.e., IT enabled services), operate in broadly similar markets, and bear broadly similar risks to that of ABC India.

The data is collected from annual / quarterly results, government reports and other sources. Searched for companies in the databases having either same 'Economic activity' and / or 'Products / Raw materials' as that of the tested party (ABC India).

Filters applied:

1. Companies for which financial data was either not available or available only up to March 2009 databases
2. Companies having zero sales or sales less than Rs. One crore in the latest year for which the financial data was available in the databases
3. Companies disclosing segmental data but whose service segments appeared to be unrelated / different from that of ABC India and companies excluded for other reasons (based on information contained in the product profile, Directors' Report, and other information available in the databases)
4. Companies whose manufacturing sales were equal to or greater than 50% of their total sales in the latest year for which the financial data was available in the databases
5. Companies whose trading sales were equal to or greater than 50% of their total sales in the latest year for which the financial data was available in the databases
6. Companies whose services appeared to be different from that of ABC India and companies excluded for other reasons (based on information contained in the product profile, Directors' Report, and other information available in the databases).

Arm's Length Range

The final set along with the weighted average NCPs using three year financial data i.e. of financial years 2009-10, 2010-11 and 2011-12 (to the extent available) are listed below:

NCPs of the Comparable Companies – Multiple Year

Sr.No	Name of the Company	NCP 2009-10 (%)	NCP 2010-11 (%)	NCP 2011-12 (%)	Weighted Average (%)
1	Caliber Point Business Solutions Ltd.	18.86	13.20	12.91	14.81
2	Cosmic Global Ltd.	16.59	8.06	NA	12.02
3	Datamatics Financial Services Ltd.	-3.73	0.39	NA	-1.53
4	e4e Healthcare Business Services Pvt Ltd	21.01	13.48	NA	16.55
5	I C R A Techno Analytics Ltd.*	24.90	24.83	17.20	21.73
6	Informed Technologies India Ltd.*	24.96	11.70	17.43	18.18
	Arithmetic Mean	17.10	11.94	15.85	13.63

NA - Not Available *Segmental Information

On the basis of the above, weighted average NCPs of broadly comparable companies range from - 1.53% to 21.73% with an arithmetical mean of **13.63%**.

NCPs of the Comparable Companies for ITES (FY 2011-12) – Single year

Sr.No	Name of the Company	NCP 2011-12 (%)
1	Caliber Point Business Solutions Ltd.	12.50

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2	Cosmic Global Ltd.	40.73
3	Datamatics Financial Services Ltd.	4.90
4	e4e Healthcare Business Services Pvt Ltd	15.79
5	I C R A Techno Analytics Ltd.*	17.20
6	Informed Technologies India Ltd.* *	8.26
	Arithmetic Mean	16.56