Sixth Report of the Committee to Review Taxation of Development Centres and the IT Sector

(Safe Harbour for Auto Ancillaries Sector – [Original Equipment Manufacturers])

17th April, 2013
FOREWORD

The Prime Minister had constituted a Committee to Review Taxation of Development Centres and the IT Sector and to recommend Safe Harbour provisions for taxpayers doing business in certain sectors. The Committee has already submitted five reports to the Government and is happy to furnish its last report today. This report is the fifth on Safe Harbour provisions. The first report, submitted on 14th September, 2012, had addressed the taxation issues confronting the IT Sector and the Development Centres. The second report (first on Safe Harbour provisions), submitted on 13th October, 2012, had laid down the recommendations for Safe Harbour provisions for the IT-Software and ITES sectors. The third report (second on Safe Harbour provisions), submitted on 18th December, 2012, had recommended Safe Harbour provisions for two areas of the financial sector, i.e., Outbound Loans and Corporate Guarantees. The fourth and fifth reports (third and fourth on Safe Harbour provisions) were submitted recently and contained the Committee’s recommendations for Safe Harbour provisions in respect of Contract R&D in the IT Services Sector and Pharmaceuticals Sector.

This report, the sixth, contains the Committee’s recommendations for Safe Harbour provisions for the Auto Ancillaries Sector [Original Equipment Manufacturers].

While furnishing this report, I must duly acknowledge the valuable contributions made by its members, namely, Ms. Anita Kapur, Member (A&J), CBDT, Ms. Rashmi Saxena Sahni, DIT (Transfer Pricing-I), Delhi and Mr. Dinesh Kanabar, Tax Expert, in examining the issues and finalizing the Committee’s approach. All of them have displayed tremendous commitment to the job at hand and a rare degree of intellectual ability to understand the complex issues. Their invaluable inputs have enabled the Committee to finalise its recommendations.

I would also like to place on record the Committee’s appreciation of the onerous work put in by the three senior officers of the Department, namely Shri Subhakant Sahu, Shri D. Prabhakar Reddy and Shri Sobhan Kar, Addl. Commissioners of Income-tax, to assist the Committee in finalizing its six reports.

Since this is the last report of the Committee, I would take this opportunity to sincerely thank the Prime Minister and the Finance Minister for reposing faith in this Committee to suggest implementable recommendations in a very complex arena of taxation. The Committee also places on record its gratefulness to the Revenue Secretary and the Department of Revenue for the support provided to it. The Committee is equally grateful to the
Chairman, Central Board of Taxes and her team of officers, led by DGIT (International Taxation), for offering unstinting support to the Committee by way of making available invaluable data pertaining to transfer pricing audits. I am personally grateful to the Chairman, CBDT for allowing me to utilise the services of some of her finest officers as Members of the Committee and for assisting the Committee.

Last, but not the least, the Committee wishes to express its gratitude to all the stakeholders [Departmental and other Government Officers, Chambers of Commerce, Industry Associations, Academicians, Companies, Professional Chartered Accountants, etc.], who provided the Committee with invaluable inputs and insights, which immensely enriched its reports.

N. Rangachary,
Chairman
17 April, 2013
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<td>99</td>
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<td></td>
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<td></td>
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Sixth Report of the Committee to
Review Taxation of Development Centres and the IT Sector

(Safe Harbour for Auto Ancillaries Sector (Original Equipment Manufacturers))

Submitted by

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Member

N. Rangachary
[Former Chairman, CBDT & IRDA]
Chairman
PART - 1: INTRODUCTION

1.1 Prime Minister’s Office issued a press release on July 30, 2012 (Annexure-I), stating that the Hon’ble Prime Minister had constituted a Committee to Review Taxation of Development Centres and the IT Sector under the Chairmanship of Shri N. Rangachary, former Chairman CBDT & IRDA. The Committee submitted its first report to the Government on 14th September, 2012 covering issues listed in the terms of reference of the Committee, except the following:

“Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector.”

1.2 The rationale for entrusting the Committee with the task of finalising Safe Harbour rules was explained in the Press Release (ibid) as follows:

“As far as Safe Harbour provisions are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer”

1.3 Vide Office Memorandum dated 13th September, 2012 (Annexure-II), the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors / activities:

(a) IT Sector

(b) ITES Sector

(c) Contract R&D in the IT and Pharmaceutical Sector

(d) Financial Transactions – Outbound loans

(e) Financial Transactions – Corporate Guarantee

(f) Auto Ancillaries – Original Equipment Manufacturers
1.4 The Committee submitted its second report, the first on Safe Harbours, on 13th October 2012 to the Government. That report contained its recommendations for Safe Harbour rules for IT and ITES sectors.

1.5 The Committee’s third report, which made recommendations for Safe Harbour rules for financial transactions of outbound loans and corporate guarantees, was submitted on 18th December 2012.

1.6 The Committee’s fourth and fifth reports, which contained Safe Harbour recommendations on Contract R&D in the IT Sector and Pharmaceutical Sector, respectively, have been submitted on 5th and 9th April, 2013.

1.7 This report, the Committee’s sixth and final, contains Safe Harbour recommendations for Auto Ancillaries – Original Equipment Manufacturers. With the submission of this report, the mandate of the Committee stands completed.

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PART - 2: DELIBERATIONS IN THE COMMITTEE

2.1 Part 2 of the first report of the Committee on Safe Harbours (Second Report of the Committee) for the IT (Software) & ITES sectors included a detailed analysis of the statutory provisions regarding Safe Harbours [Section 92CB of the Income-tax Act], the need for having Safe Harbours and the opposition to the same, types of Safe Harbours, cross country transfer pricing simplification measures, and existing transfer pricing simplification measures in India.

2.2 Since those concerns, analyses and explanations, in the view of the Committee, are equally relevant for this report, reference is invited to the said portion of the first report on Safe Harbours. However, no detailed discussion on these issues is being incorporated here to avoid repetition.

2.3 Suggestions and data to frame Safe Harbour provisions for Auto Ancillaries – Original Equipment Manufacturers were invited from the following stakeholders:

- Central Board of Direct Taxes (CBDT)
- Department of Heavy Industry
- SIAM (Society of Indian Automobile Manufacturers)
- ACMA (Automotive Component Manufacturers Association of India)
- CII (Confederation of Indian Industry)
- FICCI (Federation of Indian Chambers of Commerce and Industry)
- ASSOCHAM (Associated Chambers of Commerce and Industry of India)
- PHDCCI (PHD Chamber of Commerce & Industry)
- ICAI (Institute of Chartered Accountants of India)
- PWC (Price Waterhouse Coopers)
- E&Y (Ernst & Young)
- Deloitte Haskins & Sells
- KPMG
- BMR Advisors
• Vaish & Associates, Delhi
• SR Dinodia & Company, New Delhi
• BMW
• FIAT

2.4 Data and comments of the CBDT were received for the consideration of the Committee. The comments of DIT (Transfer Pricing), Ahmedabad, dated 13th February, 2013, forwarded by the office of the DGIT (International Taxation) vide letter dated 22nd February, 2013 to the Committee (Annexure - III), have been considered.

2.4.1 The Society of Indian Automobile Manufacturers (SIAM) has provided a general note on Transfer Pricing issues, dated 6th March, 2013, without focussing exclusively on Safe Harbour in the Auto Ancillaries Sector (Annexure-IV). The Department of Heavy Industry, Ministry of Heavy Industry & Public Enterprises, has responded vide Office Memorandum in reference No. 4(2)/2013-AE-I, dated 20th March, 2013 (Annexure-V). They have emphasised the need for clarity and have supported the contentions of SIAM. Their general suggestions include constitution of a single authority to decide the Arm’s Length Price (hereinafter referred as ALP in this report) for both direct and indirect taxes, no cherry picking of comparables, detailed Functions, Assets and Risks (FAR) analysis and use of multiple year data. Some of these have already been acknowledged in the First Report and others are not covered by the mandate of this Committee.

2.4.2 S.R Dinodia and Company, New Delhi, has suggested segregation of auto ancillaries / components sector into core and non-core and also suggested a need for Safe Harbour for royalty transactions (Annexure-VI).

2.4.3 The CII (Confederation of Indian Industry) has given a note giving suggestions for Safe Harbour in general and also with reference to this sector. The full note may be seen at Annexure-VII. It has emphasised the dependence of the Automotive Industry on know-how and other intangibles.
for design and innovative automotive systems. According to CII, the transactions of technical know-how or technical services are significantly increasing and there is an opportunity for India to leverage its large knowledge base.

2.4.4 Comments have also been received from OEMs like FIAT and BMW. However, they do not have contextual relevance with the mandate of the Committee.

***
PART - 3: SETTING THE CONTEXT

3.1 In terms of Auto industry, India is the sixth largest market after China, USA, Germany, Japan and Brazil. The auto sector reported a robust growth rate of 26% in the years 2010-11 and 2011-12 but the growth has slowed down significantly in 2012-13.

3.2 Following is the Vision 2016, as included in the Automotive Mission Plan 2006-2016 of Ministry of Heavy Industry & Public Enterprises, Government of India (hereinafter referred to as “Mission Plan”):

Quote:

To emerge as the destination of choice in the world for design and manufacture of automobiles and auto components with output reaching a level of US$ 145 billion accounting for more than 10% of the GDP and providing additional employment to 25 million people by 2016.

Unquote

3.3 The Report of the Working Group on Automotive Sector for the 12th Five Year Plan (2012-2017) (hereinafter referred to as “Report of the Working Group”) has identified this sector as a key growth driver due to its deep forward and backward linkages, which have a strong multiplier effect. According to the report, the Indian Automobile Industry is growing at a good pace after economic liberalisation in 1991. Today, the industry, according to the report, is characterised by -

• Growing number of manufacturing facilities.

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• Production of a wide variety of vehicles: passenger cars, light, medium and heavy commercial vehicles, multi-utility vehicles such as jeeps, two wheelers such as scooters, motor-cycles and mopeds, three wheelers, tractors and other agricultural equipments, etc.

• It has grown at a Compound Annual Growth rate (CAGR) of over 15% during the last 5 to 7 years, due to which it is identified as the next sunrise sector of the Indian economy.

• The volumes, exports and turnover have increased by 3.8, 19.6 and 6 times, respectively, in the last ten years.

• Increasing contribution of this sector to the National GDP, rising from 2.77% in 1992-93 to close to 6% now.

3.4 The Report of the Working Group 2 depicts the structure of the Auto Industry in India as follows:

3.4.1 There has been a steady increase in the turnover in this industry. The Report of the Working Group states as under: 3

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2 Ibid, Para 1.4
Quote:

The turnover of the auto component industry, in 2010-11 was USD 40 Billion (1,79,320 cr. approx.)\(^3\). The export of vehicles and auto components during 2010-11 stood at USD 6 Billion and USD 5 Billion respectively. In 2010-11, the contribution of the automotive industry to the manufacturing GDP and the excise duty was at 22% and 21% respectively.

Unquote

3.4.2 The Report of the Working Group \(^4\) further substantiates, in terms of value, the domestic sales turnover and exports of the Auto Ancillaries/components sector as under:

Auto components sector's performance – Estimation for 2012-17

(USD billion)

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<thead>
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<td>Domestic Market Size</td>
<td>52.6</td>
<td>58.3</td>
<td>64.5</td>
<td>71.4</td>
<td>79.1</td>
<td>10.7%</td>
</tr>
<tr>
<td>Turnover</td>
<td>48.7</td>
<td>53.9</td>
<td>59.8</td>
<td>66.3</td>
<td>73.6</td>
<td>11.0%</td>
</tr>
<tr>
<td>Export</td>
<td>7.3</td>
<td>8.7</td>
<td>10.3</td>
<td>12.3</td>
<td>14.6</td>
<td>18.8%</td>
</tr>
</tbody>
</table>

3.5 Briefly stated, at present, the automobile sector in India

- includes almost all the major global Original Equipment Manufacturers (OEMs) as well as home grown companies;

- has surpassed France, UK and Italy in 2010-11 to make India the 6th largest vehicle manufacturer globally;

\(^3\) ibid, Page 13, Para 1.5
\(^4\) ibid, Page 51
• is the largest manufacturer of tractors, second largest manufacturer of two wheelers, fifth largest manufacturer of commercial vehicles and the fourth largest passenger car marker in Asia;

• exported 2.35 million vehicles to more than 40 countries during 2000 to 2011, which included 0.45 million passenger cars and 1.54 million two wheelers; and

• provides direct and indirect employment to 13.1 million people.

3.5.1 Further, today, the Indian automobile sector has:

• 19 manufacturers of passenger cars & multi utility vehicles;
• 14 manufacturers of commercial vehicles;
• 16 manufacturers of 2 and 3 wheelers;
• 12 manufacturers of tractors; and
• 5 manufacturers of engines.

3.6 The auto ancillary or auto component sector is a highly fragmented sector in terms of types of products, vendors, market, transactions, turnover and profit margins. It has component manufacturers both for OEMs (Original Equipment Manufacturers or vehicle manufacturers) and replacement market, also called the aftermarket. This sector includes both exporters and importers of components. It has organised and unorganised sector players manufacturing both core and non-core components. There are about 500 component manufacturers in the organised sector and even a larger number in the unorganised sector.

3.6.1 The 500 organised sector players of the Indian auto component or auto ancillary sector reached a turnover of over USD 14 billion in 2005-06. Demand from OEMs account for 67% of sales while replacement market accounts for 19% at about USD 2.0 billion. This is exclusive of tyres, batteries and imported components.  

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5 Automotive Mission Plan 2006-2016, Para 2.3.7
3.6.2 Characteristics of the auto ancillary/component sector as delineated in the Mission Plan⁶ are as follows:

“Autor component industry growth is directly linked to the growth of automobile industry since more than 65% sales is to the OEMS. However, in recent years, component exports are becoming an important growth driver and it is expected to assume greater importance in future.”

3.6.3 An EXIM Bank Study⁷ also supports the above conclusion by stating that, “The trends in auto-components industry are dependent on the trends in the automobile industry, as the original equipment manufacturers are the principal customers for the auto components industry. Though there is a replacement market as well, the trends in automobiles industry still influence the growth of auto-components industry.”

3.6.4 The EXIM Bank Study⁸ also states that globally the industry:-

- is in the process of undergoing a structural change;
- is being influenced by strategies of OEMs, globalization, business and technology trends;
- is facing rise in input costs and, therefore, companies are moving to low cost destinations, so as to be cost efficient;
- is witnessing mergers and acquisitions, as well as, consolidation as most of the companies are hiving-off their peripheral businesses and concentrating on their core business;
- is witnessing more and more companies becoming system integrators rather than being mere suppliers; and

⁶ Ibid, Para 2.4.5
⁷ Indian Automotive Industry: At the cross roads, Occasional paper No.129 of Exim Bank., Dec2008, page,15
⁸ Ibid
• due to all the above trends, countries like China, India and Thailand stand to gain significantly.

3.6.5 India becoming a major player in the automobile industry (both OEMs and components sectors) is supported by the following overview provided in the Mission Plan: ⁹

• There are around 500 firms in the organised sector producing practically all types of components and more than 10,000 firms in the small unorganised sector, in a tierised format.

• The industry, over the years, has achieved high degree of indigenisation both in the vehicle (OEM) industry and in the components industry for the ‘Made in India’ vehicles like the Tata Indica, Mahindra Scorpio, Bajaj Pulsar, TVS Star and TVS Victor.

• The component or ancillary industry has developed capability to manufacture the entire range of auto-components, i.e., Engine parts, Drive parts, Transmission parts, Suspension & Braking parts, Electricals, Body and Chassis parts, Equipment, etc.

• The components-wise share of production is as follows:

  ✓ Engine parts - 31%;
  ✓ Drive and Transmission parts - 19%;
  ✓ Suspension & Braking parts -12%;
  ✓ Electrical parts - 9%;
  ✓ Body and Chassis parts -12%;
  ✓ Equipment - 10%; and
  ✓ Others (the balance of about 7%).

3.6.6 The Mission Plan ¹⁰ further indicates that the turnover of the components industry has increased from USD 3.1 billion in 1997-98 to USD 9.8

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⁹ ⁹ Automative Mission Plan 2006-2016, Page 17-18
¹⁰ ¹⁰ Ibid
billion in 2003-04. The growth can be attributed to low labour costs, availability of skilled labour and high quality consciousness among Indian vendors. In respect of exports of components from India, the Mission Plan\textsuperscript{11} observes as below:

\textbf{Quote:}

\textit{During 2003-04, the exports of auto-component crossed the magic figure of USD 1 billion after having recorded a healthy growth of 25%. During the year 2004-05, the exports grew by 40% thereby taking the direct exports of components to a level of USD 1.4 billion. In the year 2005-06 exports grew by 28% and reached the level of USD 1.8 billion. It is pertinent to mention here that this figure is still very low against the volume of world trade of 185 billion USD in auto components.}

\textit{Unquote}

3.6.6.1 An additional factor for growth in the sector, as pointed out by the Director of Income-tax (Transfer Pricing), Ahmedabad (Annexure – III), is “less stringent environmental regulations (environmental regulations have rendered the production of parts like castings cost-prohibitive in developed countries). For instance, the metal casting process generates dust and it is estimated that foundries in Europe and USA on account of stringent environmental compliance spend roughly 5-6% of their sales on pollution control. Such costs are almost negligible in countries like India and other Asiatic nations.”

3.7 As can be seen from the overview of the auto ancillary or the auto component sector, there are a variety of products in this sector and, the component industry now has the capability to manufacture the entire range of auto-components.

\textsuperscript{11} Ibid, page 19
3.7.1 As mentioned earlier, the auto components or ancillaries sector can be further sub-divided into core and non-core segments. As one of the stakeholders, M/s S.R. Dinodia and Co. has stated in its note to the Committee (Annexure – VI), core components are those without which an automobile cannot run, such as, components of engine and engine parts, transmission & steering parts and suspension & braking Parts. The DIT (Transfer Pricing), Ahmedabad, in his note sent to the Committee (Annexure-III), has also identified some important components as core components.

3.7.2 The structure of the Auto Ancillary or Component Industry can be depicted graphically as below:

![Auto Components Diagram]

12 Indian Auto Industry: Minor speed bump, but smooth ride ahead, Dinodia Capital Advisors, December 2012, page 13
3.7.3 The above discussion emphasises the fragmented nature of the auto components sector and showcases the product diversity. In the view of the Committee, therefore, there must be segregation of components into core and non-core as they are at different ends of the value chain. Thus, the above categorisation can be considered to segregate the auto components into core and non-core. The items listed above in columns A, B, and C would be considered as core components and the other items (listed in columns D, E, and F) would be treated as non-core components.

3.7.4 The relevant contribution of core and non-core components in the auto component industry is as follows:

![Classification of Indian auto component industry](image)

*Source: Annual Report FY11, ACMA*

3.7.5 As per the Report of the Automotive Component Manufacturers Association of India (ACMA), the core components segment would increase its share in the overall auto components industry by 2020, as shown below:  

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3.7.6. Further, the OEMs of developed countries, mainly from North America and Europe, are increasingly sourcing their auto components from India. Some of the important sourcing OEMs are depicted as below:
3.7.7 There is also a growing demand in the export sector for the core components. As per the ACMA’s Report on Status of Indian Automotive Industry, the exports of engine & exhaust systems may reach USD 12.50 bn by 2020 from USD 1.60 bn in 2009. Similarly, during the same period, export of transmission & steering components may reach USD 5.21 billion from USD 0.80 billion.

3.7.8 The Committee also noted the following distinction made by the DIT (Transfer Pricing), Ahmedabad (Annexure-III).

Quote:

**REPLACEMENT MARKET**

2.2.2 The huge unorganised sector typically caters to the demands from replacement market. The unorganised sector in turn is a low-cost one with the fiscal liabilities (in terms of excise duties) being not accounted for by this sector. As a result, this sector is able to supply the replacement market with significantly lower-priced parts vis-a-vis those produced by the organised sector. The after-market is highly competitive for components with a high price elasticity of demand.

14 ibid
and a tolerance of lower quality standards. A major channel of marketing and distribution for this sector is the typical roadside mechanic. The automotive component supplier also caters to the demands from the replacement market, apart from the original equipment one. Additionally, for automotive component suppliers, the prices in the replacement market are relatively higher than the prices in the original equipment market. This higher prices in the replacement market is because of the higher margins charged by the component suppliers, the impact of a longer supply chain and the tax structure. Typically, the replacement market provides higher margins but lower volumes vis-a-vis the OEM market.

Unquote

3.7.9 The Committee acknowledges that “core components” are those that require complex technology and functions in the process of manufacture and these components would form the heart of the automobile and determine its performance, including its mileage. For example, a car cannot run without an engine, clutch, and gear. However, it can run without mirror and door latches, which are non-core components. Further, these components decide the power, performance and comfort of the drive. It is also observed by the Committee, based on the analysis of margins by a stakeholder of independent companies (Annexures-VIII & IX), that the profit margins in both categories of products are also different.

3.8 Further, there is not only multiplicity of products but also variety of international transactions in this sector. This is apparent from the nature of international transactions typically reported in Form 3CEB 15, as illustrated below.

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15 Form 3CEB is the statutorily prescribed form for reporting International Transactions under the Income-tax Act.
3.8.1 General Component manufacturer/ distributor such as ABC Ltd has reported following activities for AY 2009-10:

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Description of Transactions</th>
<th>Amount (in rupees)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Purchase of raw material, components, Sub-assembly and spare parts</td>
<td>8,51,91,943</td>
</tr>
<tr>
<td>2.</td>
<td><strong>Sale of Raw Materials, consumables or any other supplies</strong></td>
<td>5,79,113</td>
</tr>
<tr>
<td>3.</td>
<td>Purchase of Tangible Movable property</td>
<td>32,53,97,370</td>
</tr>
<tr>
<td>4.</td>
<td><strong>Payment of royalty</strong></td>
<td>6,69,57,682</td>
</tr>
<tr>
<td>5.</td>
<td>Provision of Services:</td>
<td>9,66,42,439</td>
</tr>
<tr>
<td></td>
<td>Payment of Training Charges:40,87,807</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Payment of Design, Drawing &amp; Testing Charges:5,44,27,123</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Payment of Absence Fees:3,71,95,935</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Homologation Charges Received:9,31,574</td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Reimbursement of Travelling Expenses</td>
<td>80,45,679</td>
</tr>
</tbody>
</table>

Or

3.8.2 M/s XYZ Ltd, a Captive Component manufacturer/ distributor has reported following activities for AY 2009-10.

<table>
<thead>
<tr>
<th>S.N.</th>
<th>Nature of transactions</th>
<th>Value of transaction</th>
<th>Method Used</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Import of raw materials by the assessee from the AE</td>
<td>425,021,530</td>
<td>CUP/TNMM</td>
</tr>
<tr>
<td>2.</td>
<td><strong>Export/sale of components by the assessee to the AE</strong></td>
<td>178,649</td>
<td>CUP/TNMM</td>
</tr>
<tr>
<td>3.</td>
<td>Import of capital goods by the</td>
<td>13,494,192</td>
<td>CUP/RPM</td>
</tr>
</tbody>
</table>

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16 Name redacted
17 Name redacted
3.9 The analysis by the Committee indicates that the auto ancillary sector has its own peculiar characteristics due to multiplicity of products, as well as, transactions, some of which are:

- Variable margins dependent on component, both vertical (product wise) and horizontal (turnover wise), segmentation,

- Predominance of royalty transactions or transfer of technology transactions as India is an importer of auto technology.

- With breakdown of Joint Ventures, transactions such as valuation of intangibles / shares will gain primacy in the times to come.

- This sector is also characterized by supply chain management issues, development of vendor network, and also has high AMP (Advertising, Marketing and Promotion) spend.

- It also has intra-group services payments as well as intra-group financial transaction like guarantees and borrowings.
3.9.1 According to DIT (Transfer Pricing), Ahmedabad, Safe Harbours must take into account the different facets and segments of the auto component manufacturing market. This is important because the price/margin of an entity is also dependent upon the market segment in which the entity lies.

3.10 Considering the fragmented or diversified nature of the auto ancillary sector, the Committee is of the view that only auto ancillary units engaged in manufacturing and exporting auto components should be covered under Safe Harbour.

3.10.1 Further, since the purpose of Safe Harbour provisions is to provide certainty to taxpayers located in India who are generating economic activities in India, the Committee is of the view that Safe Harbour should not be available at the entity level but at the transaction level. The eligible transactions would thus be manufacturing and exporting of auto components by the taxpayer.

3.10.2 The Committee is of the view that no Safe Harbour need be recommended for royalty payments made by the Indian enterprises as the royalty rate would depend on so many factors such as:

- Type of technology / technical-know transferred
- The uniqueness of technology / technical know-how
- The period during which the uniqueness would continue
- The availability of alternatives
- The duration of the contract
- The role of technological obsolescence
- Making available the improvement
- Extent of indigenization

3.10.3 In view of the above factors, it is apparent that the payment of royalty and also its rate would depend on unique facts and circumstances of the individual case requiring a specific FAR analysis.

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18 Annexure III
3.11 The office of DGIT (International Taxation) provided the data on the value of international transactions, margins shown by the assessee and margins adopted by the TPO. This data is placed at Annexure-X and is referred to as First Set hereinafter. The First Set of data could not be used directly due to the following reasons:

- The data is mixed and includes Transfer Pricing adjustments made in the automobile sector. Hence, it is not representative of the auto components sector.

- The Committee has segregated, product-wise, the auto component industry into core and non-core as mentioned above. This segregation was not considered by the TPO while finalising the TP proceedings for the AY 2009-10 or earlier years.

- Even though the Committee did segregate the assessees into core and non-core based on their product profile, similar analysis could not be carried out for the comparables due to non-availability of their data.

- Use of incomplete data, in the view of the Committee, will create an uncertain situation and distort the comparability analysis.

3.11.1 Due to these inadequacies regarding the integrity of the above data (First Set), the Committee did not use the same while arriving at its recommendations on Safe Harbours.

3.11.2 Subsequently, data was received from the office of the DGIT (International Taxation) on the set of comparables identified by Transfer Pricing Directorate-I, Delhi, for the auto ancillaries sector (Annexure – XI). The mention of the fact that the core and non-core components manufacturers earn different margins (para 3.7.9 above) is also evidenced by the analysis carried out by the Committee on this subsequent data (referred to as Second Set hereinafter) received from the office of the DGIT (International Taxation). From the analysis it was found that the margins of independent companies

engaged in manufacture and sale of core auto components tend to be higher than that of non-core auto components. The analysis can be seen at Annexures XII & XIII. The Committee has done this detailed analysis with the help of Prowess and Capitaline databases and the annual reports of the companies, wherever required and available. The classification of these comparable companies has been made by the Committee as per the decision of segregating the sector into core and non-core auto components. This segregation is based on the products of these companies contributing predominant (>75% of sales) revenues, data available in these databases and annual reports. The sample size is fairly robust and relatively large. It also includes core and non-core auto component manufacturers. Export earnings filter / criteria has not been applied in the Second Set of independent companies, nor in the First Set of companies considered by the TPOs, which has not been used by the Committee for the reasons given in para 3.11 above.

3.11.3 The Committee also assumed that the Second Set of independent companies for the F.Y 2008-09, relevant for the A.Y 2009-10, are engaged in manufacture and sale of auto components even during the subsequent financial years, i.e., 2009-10, 2010-11 and 2011-12. Further, the Committee also made a reasonable assumption that these independent companies, which are predominantly engaged in manufacture and sale of core and non-core auto components, continue to be engaged in the same sub-segments (core or non-core) even during the subsequent financial years. Based on the above, the margins of Second Set of comparable companies for the FY 2009-10, 2010-11 and 2011-12 based on Prowess database are placed at Annexures XIV & XV

3.11.4 The Committee also took note of the report dated August 2007 of the earlier Committee under the Chairmanship of the then DIT (Transfer Pricing), Delhi wherein sectoral analysis of PLI (OP/Sales) of auto ancillaries located in Delhi (sample size was 14) showed range of margin from 2.99 to 22.11 %
(Page 97 of the report). But this report did not make a distinction between core and non-core auto components and is also outdated now.

3.11.5 In the view of the Committee, different margins for export of auto components need to be prescribed for core and non-core auto components separately, as they are distinguishable and at different ends of the value chain. The margins in respect of core components tend to be higher than non-core components.

3.11.6 There is a view within the Committee that Safe Harbour margins must recognise the following factors, which support outsourcing of manufacturing auto components to India:

- The outsourcing of auto components to India provides a competitive advantage to its parent in terms of costs and professional competence arising due to locational advantage. India has unique location-specific intangibles such as skilled workforce, and lower costs.

- In addition to the above, the issue of market premium also needs to be factored in.

3.11.7 An alternate view within the Committee is that market premium or location savings need not be factored in. The comparables chosen for the purposes of evaluation of whether the pricing is at arm’s length operate in the same location and enjoy the same market premium or location savings as are enjoyed by the auto component exporters exporting to their foreign associated enterprises. As such, once an arm’s length price is worked out and is factored in, evolving a safe harbour, there is no question of incremental factoring in of market premium or location savings.

3.11.8 After considerable discussion, the Committee decided that Safe Harbours may be considered only for enterprises carrying out manufacturing and exporting auto components. For other international transactions, appropriate FAR analysis needs to be done on a case specific basis and
hence, no Safe Harbours are recommended for such other international transactions in this sector.

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PART - 4: RECOMMENDATIONS FOR SAFE HARBOUR IN THE AUTO ANCILLARIES SECTOR – ORIGINAL EQUIPMENT MANUFACTURERS

4.1 The Committee recommends that Safe Harbour provisions should be applicable to an enterprise engaged in the manufacture and export of core and non-core auto ancillaries/components to its foreign associated enterprises, being Original Equipment Manufacturers (OEMs). An enterprise eligible for Safe Harbour may be called an ‘Eligible Enterprise’ and the transaction eligible for Safe Harbour may be called ‘Eligible International Transaction’.

4.2 The Committee recommends that the Government may consider the following while framing Safe Harbour Rules for Eligible Enterprises opting for Safe Harbour in the Auto Ancillaries/components Sector.

4.3 General Recommendations

4.3.1 The assessee should have the option of whether to go in for Safe Harbour or not for the eligible transaction and it should not be mandatory. However, Safe Harbour should not become a rebuttable presumption for an assessee who opts not to go for it and has an Arm’s Length Price (ALP) below the Safe Harbour. There has to be a directive to the Assessing Officer/TPO in this regard that they can get the international transaction bench-marked but cannot force the assessee to rebut the presumed ALP.

4.3.2 Safe Harbour would not be available to an assessee whose profits are higher than the Safe Harbour margin of the eligible transaction on account of its contracted price and such an assessee cannot be assessed at the lower presumptive ALP corresponding to the Safe Harbour.

4.3.3 Safe Harbour margin recommended may be made applicable from A.Y 2013-14, for a period of two years.
4.3.4 Further, an institutional mechanism needs to be evolved so that every two to three years, the Safe Harbour rules/margins/rates are reviewed and notified in advance so that the assessees can comply with such provisions with ease.

4.3.5 If any other international transaction is otherwise eligible for Safe Harbours, for example, loan or corporate guarantee, it will continue to be an Eligible International Transaction for the purposes of Safe Harbour.

4.3.6 Safe Harbour provisions may not be applicable if the Eligible Enterprise enters into any transaction in the nature of eligible international transaction with any Associated Enterprises (AE) located in jurisdiction as notified under section 94A of the Act or any other country/territory widely perceived as a tax haven.

4.4 Recommendations on threshold

4.4.1 The existing limit of Rs. 1 crore provided under sub-rule 2 of Rule 10D was fixed more than a decade ago. This upward revision is also justified to adjust for inflation. It may be mentioned that change in monetary parameters on account of inflation factor is part of our tax policy as is evident from the fact that the monetary limit for audit of accounts of certain persons engaged in business, as provided in section 44AB of Income Tax itself, has been revised upwards from Rs. 40 lakhs to Rs. 1 crore during the corresponding period.

4.4.2 Accordingly, the Committee recommends that the exemption from maintaining information and documentation for international transactions specified at Rs. 1 crore under sub-rule 2 of Rule 10D of the Income-tax Rules be raised to Rs 5 crore as it will reduce compliance cost for small tax payers. Tax administration will have a smaller basket for picking up cases for scrutiny facilitating optimum use of its resources.
4.4.3 The present practice of authorizing the AO to do transfer pricing audit
in select number of cases, where the aggregate value of international
transactions is less than the threshold limit (Rs. 15 crore), has reduced the
applicability of the threshold limit as a Safe Harbour while simultaneously
diluting the effectiveness of transfer pricing audit. The Committee, therefore,
recommends that the threshold of Rs.15 crore as an administrative Safe
Harbour should be specified as a statutory Safe Harbour rule itself.

4.5 Specific Recommendations

4.5.1 In the view of the Committee, the following international transactions
constitute Eligible International Transactions:

4.5.1.1 Manufacture and Export of Core Auto Ancillaries or Components

- Manufacture and Export of auto components by the Eligible Enterprise in
  the nature of core components, namely:

  i. Engine and Engine Parts including piston and piston rings; engine
     valves and parts; cooling systems and parts; and power train
     components.

  ii. Transmission & Steering Parts, including gears, wheels, steering
      systems, axles and clutches.

  iii. Suspension & Braking Parts, including brake and brake assemblies;
       brake linings; shock absorbers; and leaf springs.

4.5.1.2 Manufacture and Export of Non-Core Auto Ancillaries or Components

- Manufacture and Export of auto components by the Eligible Enterprise in
  the nature of non-core components, i.e., all components other than core
  components mentioned above, which may include but are not limited to
  the following:
i. Equipment including headlights, halogen bulbs, wiper motors, dashboard instruments and other panel instruments.

ii. Electrical parts including starter motors, spark plugs, electric ignition systems, flywheel magnetos, and other equipment.

iii. Sheet metal parts; body and chassis; fan belts; pressure die-castings; and hydraulic pneumatic.

4.5.2 Margins for Safe Harbour and the Most Appropriate Method

4.5.2.1 From the analysis of the data of the companies considered for A.Y 2009-10 (Annexures - XII & XIII), it is seen that the comparable companies (Second Set) engaged in manufacture and sale of core auto components earned an arithmetical mean margin of **7.95%** on cost, whereas companies engaged in manufacture and sale of non-core auto components earned an arithmetical mean margin of **4.26%** on cost.

4.5.2.2 The relatively lower margins in F.Y 2008-09 (A.Y 2009-10) are understandable in view of the economic circumstances that existed during that year. The year 2008-09 started with a strong economy carrying forward the momentum of previous years' growth. However, towards September 2008, global recession caught up with India and the economy slowed down significantly. The Indian Automotive Industry grew by about 4% till September 2008 and, thereafter, nose-dived. The high interest rates in combination with the non-availability of funds, adversely affected the demand for vehicles, which in turn affected the auto ancillary/component industry's performance.

4.5.2.3 The sector improved its performance gradually from 2009 onwards. This is also evident from the margins earned by these companies (Second Set), as summarised below (details can be seen at Annexures - XII, XIII, and XIV & XV):
### Description

<table>
<thead>
<tr>
<th>Description</th>
<th>Arithmetical Mean Margin of Comparable Companies</th>
<th>Arithmetical Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core Auto Components</td>
<td>7.95%</td>
<td>10.63%</td>
</tr>
<tr>
<td>Non-Core Auto Components</td>
<td>4.26%</td>
<td>5.59%</td>
</tr>
</tbody>
</table>

4.5.2.4 Subsequently, the Indian automobile industry witnessed a moderation of demand in 2012-13, notwithstanding the projections made in the Mission Plan, after the double-digit growth in sales recorded in the preceding three years. Weak macroeconomic sentiment coupled with subdued consumer confidence pulled down sales, particularly in the latter half of the year 2012-13. Domestic automobile sales grew by 6.6% in 2012 (January to November), as compared to growth of 23.20% and 26.09% during 2009-10 and 2010-11 respectively\(^{19}\).

4.5.2.5 Dun & Bradstreet has prepared a comprehensive Sectoral Outlook Report on the Automobile Sector for the year 2013 \(^{20}\) and its findings are summarized as follows:

- Achieving high growth rates is likely to be a major concern for the industry in 2013 but the auto industry is likely to gain considerably from the various initiatives on infrastructure development, rural focus and the improved road infrastructure. But it expects growth in both export and domestic auto sector to moderate in 2013.

- Automobile companies across segments continue to face tremendous pressure on profit margins due to rising inflation levels. Added to this are the heightened marketing costs incurred and heavy discounts offered by vehicle manufacturers (OEMs) to attract consumers to the showrooms. Going ahead, amidst rising market competition, new product launches, as


also product refreshes planned, OEMs are expected to increase their spend on marketing & promotional activities. Although commodity prices are not expected to witness steep hikes, overall cost and competitive pressures would keep the profit margins under pressure. This will also put pressure on the margins of auto ancillary industry as well, as they are dependent on the performance of these OEMs.

- While the long-term fundamentals of the Indian economy remain robust, the sluggish global environment has impacted sentiments in the domestic market in the short term.

4.5.2.6 The Committee also noted what the Heavy Industry Minister, Shri Praful Patel stated recently, \(^{21}\) while talking to reporters on the sidelines of the CII annual general meeting on 4th April, 2013:

*Quote:*

> Well, I am very keen that the issue of the auto industry on excise for SUVs gets resolved *because we have massive slowdown and for us the auto industry is very important for our manufacturing GDP and creation of jobs.*

*Unquote*

4.5.2.7 The Committee is also aware of the latest trend in this sector. In this regard, the Hindu Business Line Newspaper Report dated 19th March, 2013 \(^{22}\) reported as under:

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According to SIAM, passenger car sales in India plunged to a 12-year low in February, registering a 25.71 per cent decline to 1,58,513 units as high fuel prices, interest rates and low consumer sentiments took a toll.

With just a month left for the fiscal to end, SIAM had said that it was certain that car sales would be in negative territory in 2012-13, the first decline since 2002-03, missing the earlier forecast of 0-1 per cent rise for the ongoing financial year.

4.5.2.8 Considering the above facts, the Committee believes that F.Y 2012-13 has been a very difficult year for this sector and F.Y 2013-14 may also be likewise. As the demand in this industry is highly elastic to rates of interest prevailing in the economy, and interest rates are under pressure due to the inflationary expectations in the economy, the auto industry is going to be plagued by the same problems as those in F.Y 2008-09, like high interest rates combined with non-availability of funds on the demand side and inflation on the supply side.

4.6 The Committee, after detailed discussion and considering all the facts, came to the conclusion that separate Safe Harbour margins need to be prescribed for the core and non-core segments of the auto ancillaries industry. After analysing the data for auto components over the years 2008-09 to 2011-12 (Second Set), the Committee noticed that the average margin of these 4 years is 10.32% for core components and 6.25% for non-core components (reference paragraph 4.5.2.3). The Committee also noticed that there has been an upward movement of the margins over these 4 years and the margin for the latest year, i.e., F.Y 2011-12, is 11.20% for core components and 8.17% for non-core components. Taking into consideration all the above facts and also that the TPOs’ orders have not attained finality, the Committee recommends 12% as an all-inclusive Safe Harbour margin for transactions in
the nature of manufacture & export of core auto ancillaries/components. Similarly, it recommends 8.5% as an all-inclusive Safe Harbour margin for transactions in the nature of manufacture & export of non-core auto ancillaries/components.

4.6.1 Besides, the Committee is of the view that Transactional Net Margin Method (TNMM) is the most appropriate method in the case of the Eligible Enterprises, i.e., manufacturers and exporters of auto components. Thus, Operating Profit on Operating Expenses is considered as the appropriate Profit Level Indicator (PLI) for Safe Harbour under TNMM.

4.6.2 The Committee understands that for computing the above-recommended margins, the method of computing the Profit Level Indicator (PLI) is of critical importance. Operating Profit Margin is the most crucial aspect for calculating the PLI. Accordingly, the Committee recommends that “Operating Expense”, “Operating Revenue” and “Operating Profit” for the purposes of calculating PLI should be defined as follows:

- "Operating Expense" is the expense of the Eligible Enterprise incurred during the course of its normal operations and in connection with Eligible International Transactions for the previous year, including royalty / technical know-how fee incurred in connection with manufacture & export of auto components to AEs, depreciation / amortization expenses relating to assets used by the Eligible Enterprise but excluding interest expense, provisions for unascertained liabilities, pre-operative expenses, the loss arising out of translations of foreign currency items, extraordinary and other items not relating to the operating activities of the Eligible Enterprise for the previous year, the loss on sale of assets / investments of the company, and the effects relating to the income tax expense of the company.

- “Operating Revenue” is the revenue of the Eligible Enterprise earned in connection with Eligible International Transactions and during the course
of its normal operations for the previous year, but excluding interest income, the income arising out of translations of foreign currency items, the income on sale of assets or investments of the company, the refunds relating to the income tax expense of the company, provisions no longer required written back and extraordinary and other items not relating to the operating activities of the Eligible Enterprise for the previous year.

- **“Operating Profit”** is the profit earned from normal operations of the Eligible Enterprise. It is computed as the operating revenue of the Eligible Enterprise less the operating expense incurred for an accounting period.

4.6.3 If an Eligible Enterprise is into multiple activities other than Eligible International Transactions (manufacture and export of auto ancillaries/components to OEMs), then a certificate from the auditor may be prescribed to audit and certify the profitability arising under TNMM on account of the Eligible International Transactions.

4.6.4 Accounting terms used in these Rules shall be defined in accordance with generally accepted financial accounting principles in India.

4.6.5 The Committee recommends that once Safe Harbour rules are opted for by an assessee, no margin variation benefit under section 92C(2) or any other comparability adjustment such as, capacity, risk, working capital, depreciation etc. would be permitted.

4.6.6 To reduce compliance costs for the assessee, it is imperative that the documentation burden on the Eligible Enterprises opting for Safe Harbour is made less stringent, as compared to an assessee choosing regular TP documentation and scrutiny by the Department. Accordingly, the Committee recommends that such an enterprise need not maintain information and documents specified in clauses (g) to (m) of Rule 10D(1) in respect of the Eligible International Transactions.
4.6.7 The Committee clarifies that Safe Harbour rules would not give immunity from scrutiny of any international transactions other than the Eligible International Transactions that have been opted by the Eligible Enterprise to be covered under Safe Harbour.

4.7 Recommendations on Procedural/Administrative Issues.

4.7.1 An Eligible Enterprise may exercise its option for accepting the Safe Harbour for the year by filing an option form with the Assessing Officer not later than the due date for filing the Income-tax return. If necessary a new Statutory Form for exercising Safe Harbour option to be filed along with return of income may be prescribed. Alternately, the 3CEB Report should be modified to provide for indication of election of Safe Harbour option for the year along with identification of Eligible International Transactions.

4.7.2 The Committee recommends that the AO must compulsorily refer such cases to the TPO who will conduct the functional analysis to determine the Eligible Enterprise as well as the Eligible International Transaction before accepting the results of the taxpayer under Safe Harbour. Besides, there should be strict penalties if any of the eligible conditions laid down for Safe Harbour are violated by the taxpayer.

***
The Prime Minister has constituted a Committee to Review Taxation of Development Centres and the IT Sector. The Committee will engage in consultations with stakeholders and related government departments to finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector. It will also suggest the approach to taxation of Development Centres.

2. The Prime Minister had earlier set up an Expert Committee on GAAR under the Chairmanship of Dr. Partho Shome to engage in a widespread consultation process and finalise the GAAR Guidelines. The response has been overwhelmingly positive.

3. While this committee would address concerns on GAAR provisions and would reassure investors about the predictability and fairness of our tax regime, it was felt that there is still a need to address some other issues relating to the taxation of the IT Sector such as the approach to taxation of Development Centres, tax treatment of "onsite services" of domestic software firms, and also the issue of finalising the Safe Harbour provisions announced in Budget 2010.

4. Many MNCs carry out activities such as product development, analytical work, software development, etc. through captive entities in India. They exist in a wide range of fields including IT software, IT hardware, Pharmaceutical R&D, other automobile R&D and scientific R&D. These are popularly called Development Centres. Over 750 MNCs have such centres at over 1100 locations in India. The reason for this large concentration of Development Centres in India is the worldwide recognition of India as a place for cost competitive, high quality knowledge related work. Such Development Centres provide high quality jobs to our scientists, and indeed make India a global hub for such Knowledge Centres. However, India does not have a monopoly on Development Centres. This is a highly competitive field with other countries wanting to grab a share of the pie. There is need for clarity on their taxation.

5. As far as Safe Harbour provisions are concerned, these were announced in Finance Bill 2010 but have yet to be operationalised with a wide application. Safe Harbour provisions have the advantage of being a good risk mitigation measure, provide certainty to the taxpayer.

6. The resolution of the above tax issues requires a comprehensive approach in which other government departments are consulted and industry bodies are taken on board. The overall goal is to have a fair tax system in line with best international practice which will promote India's software industry and promote India as a destination for investment and for establishment of Development Centres. Therefore, the Prime Minister has constituted a Committee consisting of experts from the Income Tax Department, both serving and retired, who will examine the issues in detail and submit proposals in a short time. An arm’s length exercise of this nature will allay a lot of concerns in addition to the immediate resolution of issues that is necessary.
7. For this purpose, a **Committee on Taxation of Development Centres and the IT sector** has been constituted consisting of:

1) Shri N. Rangachary, former Chairman CBDT & IRDA - Chairman

2) Ms Anita Kapur, Director General (IT) - Member

3) Ms Rashmi Sahani Saxena, DIT (TP) - Member

4) Any other officer from the Income Tax Department to be co-opted by the Chairman

8. The **Terms of Reference of the Committee** will be to:

i) Engage in consultations with stakeholders and related government departments to finalise the approach to Taxation of Development Centres and suggest any circulars that need to be issued.

ii) Engage in sector-wide consultations and finalise the Safe Harbour provisions announced in Budget 2010 sector-by-sector. The Committee will also suggest any necessary circulars that may need to be issued.

iii) Examine issues relating to taxation of the IT sector and suggest any clarifications that may be required.

9. The Committee will work to the following time schedule:

i) Finalise the approach to taxation of Development Centres and suggest any necessary clarifications by **31 August 2012**.

ii) Suggest any necessary clarifications that may be needed to remove ambiguity and improve clarity on taxation of the IT Sector by **31 August 2012**.

iii) Finalise Safe Harbour Rules individually sector-by-sector in a staggered manner and submitting draft Safe Harbour provisions for three sectors/sub-activities each month beginning with the first set of suggestions by **30 September 2012**. All Safe Harbour provisions can be finalised by **31 December 2012**.

10. The Department of Revenue will provide all necessary support to the Committee to facilitate its work including office assistance and assistance to facilitate consultations.
OFFICE MEMORANDUM

Subject: Constitution of a Committee to Review Taxation of Development Centres and the IT Sector- Reg.

***

The undersigned is directed to refer to Department of Revenue’s O.M. of even number dated 3rd August, 2012 on the above cited subject and to say that considering the paucity of adequate data required to draft the rules, the Finance Minister has approved that the Committee may finalise the Safe Harbour Rules in the following sectors/activities:

(i) IT Sector
(ii) ITES Sector
(iii) Contract R&D in the IT and Pharmaceuticals Sector
(iv) Financial Transactions – Outbound loans
(v) Financial Transactions – Corporate Guarantee
(vi) Auto Ancillaries – Original Equipment Manufacturers

2. In view of the above, the revised timelines for submitting the reports on Safe Harbour provisions by the Committee have been modified as under:


Copy to:

1. Shri N. Rengachary, Chairman of the Committee to Review Taxation of Development Centres and IT Sector. (His kind attention is invited to note dated 12/08/2012).  
2. Ms. Anita Kapur, Director General (IT), Member of the Committee.  
3. Ms. Rashmi Saxena Sahni, DIT(TP), Member of the Committee.  
4. Shri Dinesh Kanabar, Tax Expert, Member of the Committee.  
5. Shri B.V.R. Subrahmanyam, Joint Secretary to PM.  
6. PS to FM.  
7. PS to Secretary (Revenue).  
8. Chairman, CBDT.
Annexure – III

Safe Harbour rules for Automobile Sector - Note of Director of Income-tax (Transfer Pricing), Ahmedabad

Comments have been sought on the safe harbour rules to be introduced in the Indian Income Tax Act, 1961 in Automobile sector. The salient features of Indian Automotive component manufacturing market are as below:

2. An auto component industry can be segmented on the basis of the production of component types as below
   - Engine Parts
   - Drive Transmission and Steering Parts
   - Suspension and Brake Parts
   - Electrical Parts
   - Equipments
   - Other Parts

The relevant contribution of these types in the market segment is as follows:

Classification of Indian auto component industry

Source: Annual Report FY11, ACMA
2.1 The auto component industry can also be segmented through the supply chain tierization like first tier, second tier, third tier and fourth tier as the levels of supply category and involvement in the supply chain of automobile company. The fourth tier suppliers supplies raw material as a small jobs while a second tier suppliers produces a full auto component. The first tier suppliers are identified as a OEMS/ Assemblers (Original equipment manufacturers). There are new direct suppliers, who design systems and coordinate almost the entire chain encompassing the manufacturing and assembly process and these are the Tier 1 and 0.5 who have major involvement as a supplier in manufacturing of automobiles, they provide semi – assembled modules of automobiles like steering system, rear axle system etc. which can be directly fixed on the final assembly of the cars.

2.2 The market for automotive components can be segmented into three categories based largely on the identity of the buyer:

- Original Equipment Manufacturers (OEMs - the vehicle manufacturers)
- Replacement (vehicle owners who buy parts for maintenance and repair)
- Exports (primarily foreign vehicle manufacturers and International Tier I suppliers).

**OEM SEGMENT**

2.2.1 The principal drivers of demand for the automotive components industry from the OEM segment (in number terms) are passenger cars and commercial vehicles. While OEMs are an assured source of demand for component manufactures, the OEMs also exert a great amount of pricing pressure on the component suppliers. It is the relatively large order size of the OEMs that gives them the bargaining strength.

**REPLACEMENT MARKET**

2.2.2 The huge unorganised sector typically caters to the demands from replacement market. The unorganised sector in turn is a low-cost one with the fiscal liabilities (in terms of excise duties) being not accounted for by this sector. As a result, this sector is able to supply the replacement market with significantly lower-priced parts vis-a-vis those produced by the organised sector. The after-market is highly competitive for components with a high price elasticity of demand and a tolerance of lower quality standards. A major channel of marketing and distribution for this sector is the typical roadside mechanic. The automotive component supplier also caters to the demands from the replacement market, apart from the original equipment one. *Additionally, for automotive component suppliers, the prices in the*
replacement market are relatively higher than the prices in the original equipment market.
This higher prices in the replacement market is because of the higher margins charged by the
component suppliers, the impact of a longer supply chain and the tax structure. Typically, the
replacement market provides higher margins but lower volumes vis-a-vis the OEM market.

Five factors primarily influence the aggregate annual demand for replacement parts:

- Size of the national vehicle population
- Average age of the national vehicle
- Pollution norms and Government regulations
- Average number of kilometres driven per vehicle
- Road and other related conditions.

**EXPORT MARKET**

2.2.3 International automotive players with operations in India are increasingly sourcing
components from Indian automotive component manufacturers. For instance, Hyundai and
Fiat are sourcing parts locally for their Santro and Palio models in India, respectively. The
demonstrated ability of Indian component makers to make supplies to global automotive
manufacturers in the country has opened up the possibility of the component makers
supplying the same OEMs in other countries as well. Indian component manufacturers
continue to enjoy competitive advantages primarily on the strength of the following factors:

- Low labour costs (low labour costs pulls down the total cost of production, typically
  in assembled parts such as clutches and lighting equipment). For instance, wage rates
  in India are currently 60% cheaper than that in developed markets. Dana Corp
  probably spends close to 39% of revenues on wages, as opposed to 6-7% by Indian
  forging company, Bharat Forge.
- Less stringent environmental regulations (environmental regulations have rendered
  the production of parts like castings cost prohibitive in developed countries). For
  instance, the metal casting process generates dust and it is estimated that foundries in
  Europe and USA on account of stringent environmental compliance spend roughly 5-
6% of their sales on pollution control. Such costs are almost negligible in countries like India and other Asiatic nations.

- Low minimum economic scales and possession of established technology (as in castings and forgings).

Given these competitive advantages, India is therefore widely regarded as having an advantage in terms of low labour costs, strong engineering skills, and machining and processing capabilities. Hence, labour intensive and assembly-oriented components are likely to be sourced from India. The exports of the automotive component manufacturers are targeted at the following groups of buyers:

- International vehicle majors such as Volkswagen, Volvo and so on. Exports are largely to their operations in developing countries since these manufacturers do not find it cost effective to source components from their own plants or from other local units. For instance, domestic component manufacturers such as Bharat Forge, Rico Auto, Sundaram Fasteners supply directly to global OEMs.

- Vendors who supply to component manufacturers like Delphi, Dana Corporation and Valeo. As an example, recognising the cost advantage involved, most global OEMs such as Ford, General Motors and Volvo, and Tier-I companies such as Navistar and Cummins have set up international purchase offices in India, to source components and export them to their global plants.

- Many global automobile manufacturers have identified India as a manufacturing base for some of their models, which are then exported to other countries. For instance, in the passenger car segment, Hyundai's Santro Xing and Suzuki's Alto are being exported. Two-wheeler manufacturers Yamaha Motors and Honda Scooters are also exporting some of their models. Similarly, Indian OEMs such as Bajaj Auto (World Bike 125 cc), TVS Motors and car companies such as Tata Motors (City Rover) and M&M (Scorpio) are also exporting fully built vehicles. As components form more than 50% of their cost of manufacture, the export of vehicles increases the demand for domestic auto components.

- The replacement market, which accounts for a large proportion of the exports of components from the Indian market. This is due to the fact that a significant portion of the Indian components is exported for the replacement markets for out-of-production models in these countries. As Tier-I vendors located in these countries meet the demand for current models,
the production of components for out-of-production models are outsourced to countries like India. Additionally, Indian component manufacturers are also dependent on this market for the following reason:

- Unlike the OE market, the replacement market has low volumes and high margins. The OE market in turn, although has very large and assured volumes, the pricing is very stringent and strict quality controls are in place. As a result, Indian component manufacturers in the past and even now are exporting to the replacement market.

3 The reason and rationale for discussing the above mentioned facets of Indian automobile component manufacturing market is to underline the importance of the industry segment in which the assessee pertains to. Consequently, the adoption of safe harbours is required to take into account the different facets and segments of the automobile component manufacturing market. This is important because the price/margin of an entity is also dependent upon the market segment in which the entity lies.

4. Further it is important to note that in the above discussion, the industry pertaining to automobile component manufacturers has been discussed and the automobile manufacturers have not been discussed at all.

5 The details of the entities engaged in such activities in this Directorate have already been submitted earlier.
A Note on Transfer Pricing by SIAM

Introduction:

The provisions relating to the Transfer Pricing contained in the Income Tax law of India do not provide the detailed guidelines on the practical applicability of the provisions. The transfer pricing laws in many countries like US, Australia etc provide detailed guidelines and examples to be followed by the Tax officers as well as assessees for implementing transfer pricing laws.

A detailed transfer pricing guideline should be prescribed in India which would go a long way in removing ambiguities for both the tax-officers as well as the assessees and reduce litigation burden in the country. For instance companies using foreign brand name of the AE, the revenue authorities have been disallowing large part of advertisement and marketing expenditure incurred in India claiming it to be expenses incurred for creating marketing intangible for the foreign AE. AMP expenditure paid to unrelated parties does not come under international transaction as per section 92B of the Income Tax Act 1961. AMP expenditure is incurred on own account - Benefit if any to foreign company is purely incidental.

In this situation if it is clarified by way of guidelines and examples situations in which this will be taxed as marketing intangible in India, it will go a long way in bringing certainty in this matter thus also creating a conducive atmosphere for foreign investment. Generally accepted international guidance on this should be followed unless there is any specific reason to deviate. In case of companies holding exclusive long term licenses to manufacture and sell in India no such additions for AMP can be made based on international guidance on the matter and this should be clarified in Indian guidelines to be made.

Similarly guidelines should be laid down that the composite indivisible royalty can be tested for arm’s length under TNMM method at an entity level only as type of technology and extent of technology imported by each company is different and CUP method cannot be applied. The import prices for components imported from AE to whom royalty is paid are also different from company to company depending on the technology and margins that is another reason why CUP should not be applied to test arm’s length nature of royalty expense.

With an increase in the number of International Transactions, the Transfer Pricing norms and the Transfer Pricing Law are seeing a rapid change. It is observed that, the Transfer Pricing assessments are being used as the most Revenue Generating scheme for the Government. For monitoring of the Transfer Pricing Transactions the provisions U/s 92 to 92E have been enacted with a view to provide a framework which can lead to computation of reasonable, fair and equitable pricing which affects taxation in India.
Thus, any income/expenditure from international transaction has to be computed having regard to the Arms Length Price (ALP).

There are various methods incorporated to settle down on the ALP. But, still Transfer Pricing is in its infancy and there are certain lacunas which need to be addressed. In this relation below points are suggested;

**One authority to decide the Arm’s Length Price (ALP) for both Direct and Indirect Taxes (both of which comes under the Department of Revenue of Ministry of Finance):**

It is suggested that there should be a single authority to decide the ALP of a transaction so that the same price can be used for various judicial requirements. Customs and the Income Tax departments are having opposite ends to meet. While the Customs department doubts that the import price is ‘undervalued’, the Income Tax department doubts the same as ‘overpriced’. Finally the assessee gets the hit from both the ends. Thus, may it be any arm of the Government, the price to be adopted should be the price determined by this single authority.

To support this view we may rely upon the following:

Circular No-6-P dated 6-7-1968, in which sr. no 74 which reads as

"--- In regard to the latter provisions, the Deputy Prime Minister and Minister of Finance observed in Lok Sabha (during the debates on the Finance Bill, 1968) that where the scale of remuneration of a director of a company had been approved by the Company Law Administration, there was no question of the disallowance of any part thereof in the income-tax assessment of the company on the ground that the remuneration was unreasonable or excessive."

Thus, the circular, as aforementioned, suggests that the decision by one arm/wing of the Ministry of Finance should be accepted by the other arm.

There are also judicial presidents to support this view, like the one below;

**Kinetic Honda Motor Limited V Joint Commissioner of Income Tax- 2001-(072) TII-0072-TPUN,**

The TPO should incorporate some of the characteristics of the APA mechanism to make the TP assessment more meaningful and successful.
a. **Enough time for a proper assessment:**

The tax return for a given financial year is filed by Dec. of the following assessment year, leaving 37 months to the TPO to do his assessment. But typically the assessments are conducted within the last 6 to 8 months, most of the time giving just few days (less than a week) to the assessee to respond to the queries / show cause notices.

b. **Interactive Dialogue:**

The TPO should have a dialogue as to the method and comparables used in the TP review report, discuss mutually and required to have a revised / altered / new study to arrive at proper comparables. This will avoid basic disputes, like captive unit compared with normal business units, comparison of controlled transactions, corporate guarantee / loan given to an AE compared with a banking company, etc.

c. **No Cherry Picking:**

While finalizing ALP, the Major drawback is that the loss making companies are not considered at all although it is normally settled that new companies, companies going through economic / product cycle etc. are loss making in their initial / interim phases.

Therefore, the companies chosen for the comparison should not be by cherry picking.

**Determination of Comparable and choosing an appropriate method for determination of the ALP:**

The biggest hurdle in the provisions of Transfer Pricing laws is the determination of the proper comparables. Due to non-availability of data and non-availability of the comparables there is a remote possibility of selecting a proper comparable. Depending on the comparable selected, finally depends the method of determination of ALP.

Therefore it is suggested that there should be concrete and specific directions to select the “Comparable” (which are not controlled ones and the adjustments that may be required based on the FAI analysis). Countries like USA, UK, Germany, France, Japan, Singapore and Netherlands have detailed guidelines, including that for intangibles. Further use of multiple year data should be permitted. Multiple year data captures market/business cycles and smoothen the effects of yearly aberrations, giving good results statistically. Lack of specific guidance on selection of comparable leads to wrong selection of ALP Method.
No clarity in benchmarking.

Since there is no specific provision to guide the benchmarking, this step becomes more critical. There should be specific provisions illustrating the proper and specific steps to be taken in the benchmarking process. Even though there are provisions to adjust based on the FAR analysis, the same is not practiced during the assessments.

Giving greater authority and responsibility to the TPO

Giving greater authority under the TP assessment provisions and at the same time making the TPO responsible for frivolous adjustments is expected to yield more sincere and meaningful assessments.

Filing of tax return and transfer pricing report by foreign companies

Facts

As per section 139(1) read with section 5 of Income Tax Act, every person (which includes foreign Company) having income accrued or received in India, has to file income tax return in India, even if does not have permanent establishment in India. As per section 92D read with section 92E every person (which includes foreign company) who has entered into international transaction, shall maintain transfer pricing documents and shall file TP (transfer pricing) certificate with tax authorities.

Indian Company is deducting TDS from taxable payments to Foreign Company and TDS return with all details is filed with tax authorities. Indian company is also filling TP certificate with all detail of transactions with Foreign Company with tax authorities.

Suggestion

It is irrational to burden foreign companies to file TP report and Income Tax return for similar transactions already reported by Indian Company and on which due tax has already been deducted by Indian Company. In other countries also it seems that foreign companies are exempted from such compliances.

In our view, unless foreign company has a Permanent Establishment in India, in respect of incomes earned from India, the foreign company shall not be required to file TP report relating to Indian Transfer Pricing regulations and filing of tax return with tax authorities in India.

Provisions can be made that foreign companies shall be exempted from filling income tax return and TP certificate with tax authorities.
Applicability of Domestic Transfer Pricing provisions

Transfer pricing provisions were made applicable to domestic related party transactions by Finance Act, 2012. The provisions were inter-alia made applicable to all transactions (where aggregate of such transactions is above Rs.50 Mn) covered u/s 40A of the Income Tax Act, 1961. A large number of transactions between domestic related parties covered under Sec.40A involves parties who are subject to similar tax rates/status, where the applicability of these provisions is unwarrented as, even if some mis-pricing was assumed, there was no loss to the revenue on an overall basis. In such cases, the applicability of these provision significantly adds to the administrative burden of the Income Tax department as well as the assesses without proper justification.

The TP provisions on domestic transactions do not allow for a corresponding set-off of TP adjustment made in one party in the other related party, which is unjustified considering that both parties are under the same tax-jurisdiction. It amounts to taxing the same income twice i.e. in the hands of both the related parties.

Appropriate amendments should be made to the above provision exclude cases where both the related parties are under similar tax-status and/or allow corresponding set-off of TP adjustment made in party to the other related party.

Constitution of Dispute Resolution Panel (DRP)

The Dispute Resolution Panel (DRP) has so far been mostly an ineffective institution in resolution of transfer pricing disputes. It should be re-constituted as an independent body similar to the proposed “Approving panel” under the GAAR scheme which is proposed to be comprised of 3 members including a Chairperson being current or retired HC judge, a Chief Commissioner of IRS and an independent academic expert in tax/business matters.

This will lend a lot of credibility and independence to the DRP and help to achieve the objective for which the DRP was originally set up i.e. for faster resolution of Transfer pricing disputes.
Annexure – V

Office Memorandum of Department of Heavy Industry

Ref. No. 4(2)/2013-AE-1

Dated: 20th March, 2013

The undersigned is directed to refer to D.O letter No. DIT/TP-I/89/Delhi/2012-13/1006 dt. 25.02.2013 from Mrs. Rashmi Saxena Sahni, Director of Income Tax (Transfer Pricing)-I, addressed to Secretary, DHI enclosing therewith a D.O letter dt. 10.12.2012 of Shri N. Rangachary, Chairman, and Committee to Review Taxation of Development Centres and IT Sector seeking DHI views on the issue of having a Safe Harbour in respect of Original Equipment Manufacturers in the Auto Ancillaries sector.

The views of industry representatives i.e. SIAM have been taken on the issue. It is understood that SIAM has already furnished their views in the matter to Directorate of Income Tax (Transfer Pricing)-I, however a copy of note on transfer pricing by SIAM is enclosed herewith.

SIAM has informed that the provisions relating to the Transfer Pricing contained in the Income tax law of India do not provide the detailed guidelines on the practical applicability of the provisions and suggested that a detailed transfer pricing guideline should be prescribed in India which would go a long way in removing ambiguities for both the tax-officers as well as the assesses and reduce litigation burden in the country. For instance AMP expenditure paid to unrelated parties does not come under international transaction as per section 928 of the Income Tax Act 1961. AMP expenditure is incurred on own account. In case of companies holding exclusive long term licenses to manufacture and sell in India no such additions for AMP can be made based on international guidance on the matter and this should be clarified in Indian guidelines to be made.

SIAM has further suggested that guidelines should be laid down that the composite indivisible royalty can be tested for arms length under TNMM method at an entity level only as type of technology and extent of technology imported by each company is different and CUP method cannot be applied. The import prices for components imported from AE to whom royalty is paid are also
different from company to company depending on the technology and margins and that is another reason why CUP should not be applied to test arms length nature of royalty expense.

SIAM has informed that at present the Transfer Pricing assessments are being used as the most Revenue Generating scheme for the Government whereas transfer pricing is still in its infancy and there are certain lacunas which need to be addressed. Also SIAM has suggested the following measures for addressing the issues-

(i) There should be a single authority to decide the ALP of a transaction so that the same price can be used for various judicial requirements.

(ii) Enough time should be given to assessee to respond to the queries / show cause notices.

(iii) The TPO should have a dialogue as to the method and comparables used in the TP review report, discuss mutually and required to have a revised / altered / new study to arrive at proper comparables.

(iv) While finalizing ALP loss making companies are not considered. It is normally settled that new companies, companies going through economic / product cycle etc. are loss making in their initial / interim phases. Therefore, the companies chosen for the comparison should not be by cherry picking.

(v) The biggest hurdle in the provisions of Transfer Pricing laws is the determination of the proper comparables. Due to non-availability of data and non-availability of the comparables there is a remote possibility of selecting a proper comparable. There should be concrete and specific directions to select the “Comparable” (which are not controlled ones and the adjustments that may be required based on the FAR analysis) as is being done in countries like USA, UK, Germany, France, Japan, Singapore and Netherlands which have detailed guidelines, including that for intangibles.

(vi) There should be specific provisions illustrating the proper and specific steps to be taken in the benchmarking process. Even though there are provisions to adjust based on the FAR analysis, the same is not practiced during the assessments.

(vii) The TP provisions on domestic transactions do not allow for a corresponding set-off of TP adjustment made in one party in the other related party, which is unjustified considering that both parties are under the same tax-jurisdiction. It amounts to taxing the same income twice i.e. in the hands of both the related parties. Appropriate amendments should be made to the above provision to exclude cases where both the related parties are under similar tax-status and/ or allow corresponding set-off of TP adjustment made in party to the other related party.
(viii) The Dispute Resolution Panel (DRP) has so far been mostly an ineffective institution in resolution of transfer pricing disputes. It should be reconstituted as an independent body similar to the proposed ‘Approving panel’ under the GAAR scheme. This will lend a lot of credibility and independence to the DRP and help to achieve the objective for which the DRP was originally set up i.e. for faster resolution of transfer pricing disputes.

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Annexure – VI

Note from S.R. Dinodia and Company in respect of the Auto Ancillaries Industry in India

I. Indian Auto Industry

The Indian Auto industry is transforming itself from a low volume, highly fragmented one into a competitive industry, and backed by competitive strength, technology and transition up the value chain. Auto industry is a very wide arena and includes entities that are engaged in manufacturing various ancillary parts like seat belts, engine parts, lighting parts, etc for automobile manufacturers.

Broadly the Indian Auto Industry can be divided into the automotive sector and the auto component sector.

The forte of the Auto Industry is constantly evolving and innovative technology that meets the demands of a highly competitive market. The major product offerings in the automotive sector are passenger motor vehicles, commercial vehicles – HCV/LCV, two wheelers and three wheelers. A comprehensive structure is presented on slide no. 11 of the attached pdf report.

It may be said that the auto component industry comprises of mainly Engine & Engine Parts, Transmission & Steering Parts, Suspension & Braking Parts, Equipment, Electrical Parts, Others like sheet metal parts, chassis, die castings etc. A comprehensive structure of auto component is also presented on slide no. 12 of the attached pdf.

Out of the above industries in auto sector, it may be said that some of the components are core to the automobile without which it cannot run. The automobile ancillary market could be bifurcated in the core components and the non-core components. Broadly, the components of engine and engine parts, Transmission & Steering parts and Suspension & Braking Parts should be covered in the core components. The rest of the components are part of non-core.

Core components are those that require complex technology and functions in the process of manufacture and these components would form the heart of the automotive. Example, a car can’t run without an engine, clutch, and gears however it can run without mirror and door latches which are non core activities.
A company manufacturing engine parts which is a core component requiring complex functions, high investment in assets and therefore bears a high risk, usually gets remunerated by an automotive manufacturer better than those manufacturing non-core components such as lights, switches, mirrors, etc. It is like comparing the heart with the eye.

The profitability of the industry would depend upon the functions performed, assets utilized and the risks borne in each segment of the auto ancillary industry. A person would ready to pay more to the manufacturer performing complex functions producing a core component than the person dealing in non core components. As per settled principle, more risk and more reward. A person undertaking manufacturing of core activities will expect more return.

Based on the above philosophy, we have run a search process in order to find out the companies in the automotive industry and auto ancillary industry and the search has been conducted separately for core as well as non-core components. During the search process we have selected those companies, for which data is available as on 31st March, 2012.

A. **Core Functions/ Activities**

We have selected the companies engaged in the below mentioned industries:-

- like '%Auto Ancillaries - Axles / Shafts%'
- like '%Auto Ancillaries - Brakes%'
- like '%Auto Ancillaries - Clutches%'
- like '%Auto Ancillaries - Engine Parts%'
- like '%Auto Ancillaries - Gears%'
- like '%Auto Ancillaries - Shock Absorbers%'
- like '%Auto Ancillaries - Wheels%'
- like '%Automobiles - LCVs/HCVs%'
- like '%Automobiles - Motorcycles / Mopeds%'
- like '%Automobiles - passenger cars%'
- like '%Automobiles - Scooters and 3-Wheelers%'
- like '%Automobiles - Tractors%'

The above search filtered 57 companies. Further the core activities in auto industry can be classified into three segments as follows:-

- **Automobiles**
- **Auto Ancillary- Gears**
• Other core activities

Then we have refined our search by removing the outliers having abnormal loss or abnormal profit in that respective industry then calculated the average profit level indicator of the companies. The detailed PLI Calculations are as per attached excel file, which shows in the Auto Ancillary space the gear making companies earn the maximum margin (Avg. 12%), the other core component manufactures earn an average of 7% or more while the non core component manufactures earn on average 5% or below.

It is to be noted that we have calculated the normal margins based on the figures available on the face of the profit and loss account without considering the other factors like functions performed, assets employed and risk assumed and we have not done any analysis on operating and non operating nature of each expenses.

B. Non Core Functions/ Activities

Same way we have run a search process to find out the average margin of companies engaged in non core activities/ functions in auto sector.

We have selected the companies engaged in the below mentioned industries:-

like '%Auto Ancillaries - Batteries%'
like '%Auto Ancillaries - Electrical%'
like '%Auto Ancillaries - Friction Materials%'
like '%Auto Ancillaries - Lamps%'
like '%Auto Ancillaries - Others%'
like '%Auto Ancillaries - Plastic Mouldings%'
like '%Auto Ancillaries - Sheet Metal%'
like '%Auto Ancillaries - Springs%'
like '%Auto Ancillaries - Trading%'

The above search filtered 73 companies. Then we have refined our search by removing the outliers having abnormal loss or abnormal profit in that respective industry. After exclusion of 19 outliers, we have calculated the average margin and which turned 5.52% (PBT/Total Expense). Excel attached.
It is to be noted that we have calculated the normal margins based on the figures available on the face of the profit and loss account without considering the other factors like functions performed, assets employed and risk assumed and we have also not done any analysis on operating and non operating nature of each expenses.

II. Distinction between Royalty and Fees for Technical Services and why there is not overlap between the two.

Licensing may be defined as an arrangement between two parties, where one party has proprietary rights over some information, process, or technology protected by a patent, trademark, or copyright. This arrangement, specified in a contract, requires the licensee to pay a royalty or some other specified sum to the holders of the proprietary rights (licensor) in return for permission to copy the patent, trademark, or copyright. It is concerned with granting rights to use commercially valuable intellectual property.

License is an indivisible, non transferable right and without the right to grant sub license to manufacture, assemble and sell the products for automobiles. Royalty is paid for the license granted.

It would be incorrect to hold that if a person is paying royalty for license, then he will get the technical support and guidance from the licensor free of cost. Basically royalty is for the license to use a particular technology, however technical know how fees and technical guidance fees is related to the information of how to use the technology in a better way. In automobile industry, Indian company pays royalty for the license granted by the foreign company and in addition to the agreement for payment of royalty it also enters into agreement with the foreign company for technical support and guidance and for which it pays technical know how fees and guidance fees.

Under the agreement, the foreign company sends their employees for technical guidance, training and support for which Indian Company pays technical guidance fees.

Mere granting of license does not itself provide the way of using that license. A person would always be in the need of continuous support and guidance in order to update the knowledge and to know the better use of the license. Hence, grant of license and continuous guidance would be separate transactions for which they have entered into separate agreements. Therefore, both the transactions have separate relevance and these two can not be combined in order to see as a one transaction.
Note from Confederation of Indian Industry (CII)

I. Suggestions regarding Safe Harbor provisions for the auto ancillaries sector

General
Transfer Pricing provisions, generally being anti-avoidance in nature, contains a certain amount of rigor with considerable onus on the tax payer. Such a rigour may create bottlenecks in the environment to do the business due to static nature of the law. The rigid provisions in the transfer pricing provisions especially impact the automotive industry which is cyclic in nature and depends considerably on technology and knowledge base available outside India.

Outside India, the International Transfer Pricing regulations have been practiced for many years. Over the years most of the international transfer pricing jurisdictions have taken many steps to make the transfer pricing process more judicious for the taxpayer. Such steps are as under:

a) Transparent guidelines regarding methods.
b) Advanced Pricing Arrangements.
c) Mutual Agreement Procedure (MAP)

The Safe Harbour provisions are intended to work in situations where, considering the taxpayer’s facts and the country situation, the above measures are not sufficient to substantiate the tax incidence on a judicious basis.

There is need for formulating an appropriate mechanism which would address the realistic difficulties faced by the Indian tax payer with regard to the Safe Harbour provisions. In other words, Safe harbour provision cannot be taken as substitute for transparent transfer pricing mechanism.

Certain important suggestions on Safe Harbor Regulations

- **Comparability**
  Inter-quartile range should be adopted in place of arithmetic mean, as the inter-quartile range indicates the distribution/ spread in which “normally” (i.e. under non-influenced circumstances) one person falls if other circumstance of industry and level of operations are same/ similar. Inter-quartile range, being a reflection of the “normal distribution” automatically rejects the unreasonable or extreme results. On the contrary the arithmetic mean is a point which would never be achievable by any independent business, even if the industry and level of operations are same. This is because there would be finer differences like availability of own space as against leased premises, etc which will impact the profitability and in turn will not be achieved in the arithmetic mean”.

- **Range of mark up and similar assertions**
  The Indian Automotive Industry is subject to severe competition, both in the domestic and international markets. Hence, the transactions with Associated Enterprise (AE) for sourcing or selling the components (with a view to leverage the resource base) are increasing.
  The Automotive Industry depends on know-how and other intangibles for the design and innovative automotive systems. The transactions of technical knowhow or technical services are significantly increasing. There is an opportunity for India to leverage its large knowledge base.
In the above situations, the advance pricing arrangements may not provide sufficient solution in each case. The safe Harbour provisions could support the following:

a) Ranges percentage of mark-up over the total cost in respect of transaction involving sale or purchase of components.

b) Range of rates for royalty or towards use of technical know-how.

c) Indian automotive industry is availing services from Foreign AEs as technology in Europe, America and Japan is more advanced than in India. Further, such services are purely for the benefit of development and for nurturing the Indian automotive industry. Hence, Safe Harbour provisions should fix a mark-up of around 12.5% to 15% for such transactions towards payment for technical services.

- **Intangible asset valuation**
  
  There are a range of assumptions for valuation of intangibles in terms of product life cycle and EBITDA earnings. These assumptions are critical and most litigated and should be re-considered.

- **Distribution mark-up in India**
  
  Distribution of vehicles or components or parts is a routine function. To reduce the burden of compliance cost in respect of such routine transactions, we may fix a mark-up of around 1 – 2% of the value of vehicle or 10% over the value added cost as the safe harbor mark-up

- **Exports**
  
  a) In order to promote the competitiveness of Indian automotive industry in the international markets, the Safe Harbour provisions should prescribe a reasonable range of margin on exports to AE. This should be over and above the APA mechanism.

  There should be similar guidance on the percentage of commission on exports

II. **Transfer Pricing Issues & Recommendations for Auto ancillaries**

The auto ancillaries sector in India consists of original equipment manufacturers (OEM), contract manufacturers and trading companies

It has witnessed that different types of automotive components govern a different rate of return. Hence, the application of differential safe harbours to different categories of auto ancillaries may be considered, although generally, a net operating profit margin/return of **3-5 percent** from manufacturing activities may be considered to adequately compensate for the functions and risks normally undertaken by an OEM. Some issues and suggestions pertaining to differential safe harbour are as under:

- **Issue**
  
  1. Variation in business cycles - not given due cognizance

- **Explanation**
• Demand in the auto industry is heavily dependent on the economic situation and circumstances.

Market / business cycle variations may not always be reflected in the financial statements of the comparable companies.

Remark/suggestion
Losses on account of lower business volumes and slack in demand must be determined and factored while assessing taxpayers’ operating margins

Issue
2. Taxpayers’ claim for adjustment on account of under utilized capacity - rejected in most cases.

Explanation
In most cases, auto ancillary production units operate at less than optimum capacity and due to such under-utilization of capacity the fixed overhead cost remains unabsorbed

Remark/suggestion
• Unabsorbed fixed cost should be treated as ‘non-operating’ item of expense.
• Components of fixed costs must be determined depending on facts and circumstance of each taxpayer’s case.

Issue
3. Payment of royalty / FTS – disallowed on the pretext that benefits to the taxpayer are not identifiable

Explanation
• Indian affiliates normally require assistance in the form of technology & know-how, technical assistance, training for use of imported technology etc.
• In many cases, Indian affiliates may also require technical guidance in relation to specialized processes in manufacturing etc

Remark/suggestion
• Quantification of direct benefits would not be possible in most cases, since every penny incurred for the business may not have a directly identifiable benefit / outcome.
• Cost may even be incurred for attaining competitive edge or even smooth functioning of business operations.
• Nature of business operation and extent of dependence on technology and technical assistance should be given due cognizance and hence payment
for use of technology or IP needs to be accepted since the IP owner incurs huge cost on research and development.

III. Transfer Pricing Issues: Arms Length Price (ALP)

Introduction

The provisions relating to the transfer pricing contained in the Income tax Act do not provide the detailed guidelines on the practical applicability of the provisions. The transfer pricing laws in many countries like US, Australia etc provide detailed guidelines and examples to be followed by the tax officers as well as assessees for implementing transfer pricing laws.

A detailed transfer pricing guideline should be prescribed in India. This would go a long way in removing ambiguities for both the tax-officers as well as the assessee and reduce the burden of litigation in the country. For instance, for companies using a foreign brand name of the AE, the revenue authorities have been disallowing a large part of advertisement and marketing expenditure incurred in India claiming it to be expenses incurred for creating marketing intangibles for the foreign AE. AMP expenditure paid to unrelated parties does not come under international transaction as per section 92B of the Income Tax Act 1961. AMP expenditure is incurred on own account - benefit if any to foreign company is purely incidental.

In this situation if it is clarified by way of guidelines and examples, situations in which this will be taxed as marketing intangible in India, it will go a long way in bringing certainty in this matter thus also creating a conducive atmosphere for foreign investment. Generally accepted international guidance on this should be followed unless there is any specific reason for deviation. In case of companies holding exclusive long term licenses to manufacture and sell in India, no such additions for AMP can be made based on international guidance on the matter and this should be clarified in Indian guidelines to be made.

Similarly guidelines should be laid down that the composite indivisible royalty can be tested for arms length under TNMM method at an entity level only as the type of technology and extent of technology imported by each company is different and CUP method cannot be applied. The import prices for components imported from AE to whom royalty is paid also varies from company to company depending on the technology and margins and that is another reason why CUP should not be applied to test arms length nature of royalty expense.

With an increase in the number of international transactions, the transfer pricing norms and the transfer pricing law are witnessing a rapid change. It is observed that the transfer pricing assessments are being used as the revenue generating scheme for the Government. For monitoring of the transfer pricing transactions the provisions U/s 92 to 92F have been enacted with a view to provide a framework which can lead to computation of reasonable, fair and equitable pricing which affects taxation in India. Thus any income/expenditure from international transaction has to be computed having regard to the Arms Length price (ALP).
There are various methods to settle down on ALP. But still transfer pricing is in its infancy and there are certain lacunas which need to be addressed. Some such points are given below:

**Issue**

4. One authority to decide the Arm’s Length Price (ALP) for both Direct and Indirect Taxes (both of which comes under the Department of Revenue of Ministry of Finance)

**Remark/suggestion**

It is suggested that there should be a single authority to decide the ALP of a transaction so that the same price can be used for various judicial requirements. Customs and the Income Tax departments are having opposite ends to meet. While the Customs department doubts that the import price is ‘undervalued’, the Income Tax department doubts the same as ‘overpriced’. Finally the assessee gets the hit from both the ends. Thus, may it be any arm of the Government, the price to be adopted should be the price determined by this single authority.

(a) **Enough time for a proper assessment**

The tax return for a given financial year is filed by December of the following assessment year, leaving 37 months to the TPO to do his assessment. But typically the assessments are conducted within the last 6 to 8 months, most of the time giving just few days (less than a week) to the assessee to respond to the queries / show cause notices.

(b) **Interactive Dialog**

The TPO should have a dialogue as to the method and comparables used in the TP review report, discuss mutually about the requirements to have a revised / altered / new study to arrive at proper comparables. This will avoid basic disputes, like captive unit compared with normal business units, comparison of controlled transactions, corporate guarantee / loan given to an AE compared with a banking company, etc.)

(c) **No Cherry Picking**

While finalizing ALP, the major drawback is that the loss making companies are not considered at all although it is normally settled that new companies, companies going through economic / product cycle etc. are loss making in their initial / interim phases.

Therefore, the companies chosen for the comparison should not be by cherry picking.

**Issue**

5. Determination of Comparable and choosing an appropriate method for determination of the ALP.
Explanation
The biggest hurdle in the provisions of transfer pricing laws is the determination of the proper comparables. Due to non-availability of data and comparables there is a remote possibility of selecting a proper comparable. Depending on the comparable selected, finally depends the method of determination of ALP.

Remark
It is suggested that there should be concrete and specific directions to select the “Comparable” (which are not controlled ones and the adjustments that may be required based on the FAR analysis). Countries like USA, UK, Germany, France, Japan, Singapore and Netherlands have detailed guidelines, including that for intangibles. Further use of multiple year data should be permitted. Multiple year data captures market/business cycles and smoothen the effects of yearly aberrations, giving good results statistically. Lack of specific guidance on selection of comparable leads to wrong selection of ALP Method.

No clarity in benchmarking.
Since there is no specific provision to guide the benchmarking, this step becomes more critical. There should be specific provisions illustrating the proper and specific steps to taken in the benchmarking process. Even though there are provisions to adjust based on the FAR analysis, the same is not practiced during the assessments.

Giving greater authority and responsibility to the TPO
Giving greater authority under the TP assessment provisions and at the same time making the TPO responsible for frivolous adjustments is expected to yield more sincere and meaningful assessments.

Issue
6. Filing of tax return and transfer pricing report by foreign companies

Explanation
As per section 139(1)read with section 5 of Income Tax Act, every person (which includes foreign Company )having income accrued or received in India, has to File income tax return in India, even if does not have permanent establishment in India.

As per section 92D read with section 92E every person (which includes foreign company) who has entered into international transaction, shall maintain transfer pricing documents and shall file TP (transfer pricing) certificate with tax authorities.

The Indian Company is deducting TDS from taxable payments to Foreign Company and TDS return with all details is filed with tax authorities. Indian company is also filling TP certificate with all detail of transactions with Foreign Company with tax authorities.

Remark
It is inappropriate to burden foreign companies to file TP report and Income Tax return for similar transactions already reported by Indian Company and on which due tax has already been deducted by Indian Company. In other countries also it seems that foreign companies are exempted from such compliances

Industry is of the opinion that unless foreign company has a Permanent Establishment in India, in respect of incomes earned from India, the foreign company shall not be required to file TP report relating to Indian Transfer Pricing regulations and filing of tax return with tax authorities in India.

Provisions can be made that foreign companies shall be exempted from filling income tax return and TP certificate with tax authorities.