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India

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IT Sector in India

This article analyses the IT sector in India, the impact of the COVID-19 crisis and transfer pricing issues in the IT sector.

1. Introduction with Focus on India

Information technology (IT) refers to various computing and new communication technologies covering the development, maintenance and use of computer software, hardware and networks.

The Information technology industry in India has played a key role in putting India on the global map and India is now the global centre for IT. The IT and Business Process Management (BPM) sector is one of the most important growth catalysts for the Indian economy contributing considerably to India's gross domestic product (GDP)^[1] and public welfare. The industry has played a major role in transforming India's image from a slow-moving bureaucratic economy and offering traditional outsourced data entry, to a land of strengthening its digital capabilities and deploying emerging technology solutions, and becoming a global player in providing world class technology solutions and business services.

The IT industry accounted for 8% of India's GDP in 2020 and it is expected to contribute 10% to India's GDP by 2025.^[2] According to the National Association of Software and Service Companies (NASSCOM), the Indian IT industry's revenue touched USD 227 billion in financial year (FY) 2022,, i.e., 1 April 2021 to 31 March 2022, a 15.5% year over year growth. As per a survey by Amazon Web Services (2021), India is expected to have nine times more digitally skilled workers by 2025. This indicates that a total of ~ 3.9 billion digital skill trained workforce is expected by 2025.^[3]

According to the NASSCOM Enterprise CXO Survey 2022, 60% of the CXOs indicate a 6% higher technology spend in 2022 over 2021, with focus areas around customer service, supply chain, and sales and marketing. End-user enterprises are emerging as technology job creators; about 30% of respondents intend to increase their technology team by over 15%. FY 2023 growth estimates for the technology industry reflect the optimism of FY 2022. 72% of the CEOs indicate 2022 technology spend to be in line with 2021 (NASSCOM Tech CEO Survey 2022). Various research and development investments are expected to have grown between 10% and 20% over the last year.^[4]

The IT-BPM industry's (excluding e-commerce) total revenue crossed the USD 200 bn mark to reach USD 227 bn in FY 2022. The export revenue from this industry (excluding e-commerce) has been estimated at close to USD 178 bn in FY 2022. In terms of foreign direct investment (FDI) inflow, the computer software and hardware sectors attract the second highest FDI and in between April 2000 and March 2022, it attracted over USD 85 bn.^[5]

Further, India is one of the most preferred destinations and plays host to a flourishing Global Capability Centres (GCCs) community. GCCs are creating significant value within the Indian technology Industry. In FY 2021, more than 1,430 GCCs have more than 2,300 GCC units in India, employing more than 1.38 million professionals. Over 45 new data centres are expected to come up in India by 2025. Investment in Software-as-a-Service (SaaS) has increased 62.5% over 2021 and is expected to reach USD 6.5 bn in 2022. There are over 1,150 active Indian SaaS companies; 17 of which have achieved the unicorn status.^[6]

The R&D spending is back in focus and over 75% of the CEOs have expressed their confidence in achieving double-digit revenue growth. The sentiment is truly resilient and resurgent! These testing times have accelerated the challenges too. Further, as hybrid work models

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1. GDP is the most commonly used measure for the size of an economy.

2. See <https://www.ibef.org/industry/information-technology-india> (accessed 13 Oct. 2022).

3. See <https://www.financialexpress.com/industry/indian-it-revenues-grow-fastest-in-a-decade-to-usd-227-bn-in-pandemic-hit-fy22/2434619/> (accessed 13 Oct. 2022).

4. See <https://community.nasscom.in/communities/bpm/technology-sector-india-2022-resilience-resurgencestrategic-review> (accessed 13 Oct. 2022).

5. See <https://www.investindia.gov.in/sector/it-bpm> (accessed 13 Oct. 2022).

6. See <https://community.nasscom.in/communities/global-house-centers/global-capability-centers-gccs-india-reimagine-future> (accessed 13 Oct. 2022).

evolve, coherent policies and continuous communication will be required and security measures would need to evolve, to provide safety to data and secret information of clients.^[7]

The government of India has also undertaken some major initiatives to promote the IT and information technology enabled services (ITeS) sector in India. Both Central and State governments in India have taken steps towards developing technology solutions to digitally enable citizen services. The government plans to focus on areas such as cybersecurity, hyper-scale computing, artificial intelligence and blockchain.

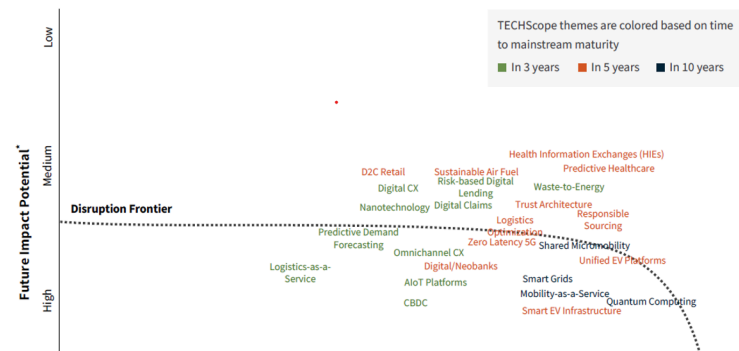
The Indian telecom industry is offering 1GB mobile data at USD 0.086, which is one of the cheapest rates globally. The advantage to consumers by offering such affordable data is easy access to services like banking, business dealings, hospitality, governance and more. Further, India has now the second highest number of internet subscribers in the world. The regulatory atmosphere is also friendly, as it provides 100% FDI in data processing, software development and computer consultancy services, software supply services, business and management consultancy services, market research services, technical testing, and analysis services, under the automatic route.^[8]

NASSCOM TECHScope offers a view of the 25 highest priority technology solutions that will invite large investments; these solutions will have a strong impact on the core industry, the value chain, and the overall Indian economy. See Figure 1.

Figure 1

Top 25 NASSCOM TECHScope Themes

2022 and Onwards



Source: Nasscom-Annual-Strategic-Review-Executive-summary-2022.

2. Opportunities and Challenges in IT/ITeS Sector in India

The IT sector will see greater offtake of productivity software, cybersecurity solutions, etc. Over time, the Indian IT industry has evolved and has created a sizeable product business market opportunity locally. The improvements in the talent and support ecosystem, innovations in software product technology, delivery/business models and changes in the Indian economy are helping in the development of the domestic market. India's tax policy initiatives of granting various incentives under Income-tax, Customs, Excise and local VAT exemptions have been growth catalysts in the industry.

The factors that have contributed to the increase in demand for IT services in India and the United States are: higher COVID-19 vaccination rates, launching of new products and service lines to make sure businesses are prepared to withstand the disruptions caused by COVID-19, return to normal commerce patterns i.e., normalized consumer buying behaviour, automation in industries to help in continuing business, even if any disruptions are caused, labour costs and availability of skilled workers.

The following additional factors that have contributed to the increase in demand for IT services in India are low cost of operation and tax advantages, adoption of new technologies like cloud computing, artificial intelligence, big data, etc., availability of technically skilled manpower, supportive government policies, government established special economic zones (SEZs), which are entitled to various regulatory and fiscal incentives.

The rapid pace of change, mounting pressure to accelerate digital transformation and a shortage of software developers have made it difficult for teams to meet these software development changes. The pandemic and the move to work from home has accelerated the need for digital workplace platforms that can help organizations in their workflow. The biggest challenge in the IT industry is the lack of skilled developers, which has led to the development of new innovations and platforms such as no-code or low code tools that allow the stakeholders to build software. Further, to meet the added demands and growth in 2022, the IT industry/software developers are taking advantage of new tools and technologies that allow them to work more effectively from home.

7. See <https://nasscom.in/sites/default/files/publication/nasscom-annual-strategic-review-executive-summary-2022.pdf> (accessed 13 Oct. 2022).

8. See <https://www.investindia.gov.in/foreign-direct-investment> (accessed 13 Oct. 2022).

New digital workspace platforms are enabling the teams to align on projects and responsibilities as well as organize tasks in a centralized application, allowing the same to be completed in an efficient and effective manner. Software developers use new solutions to become more customer centric in the provision of services. This leads to maximizing value and creating new initiatives that help to meet customer demands and eliminate pain points and achieve true transformation.

Further, the changes that have taken place in the US job market have also had the effect of increasing the recruitment of talent in India and consequently, the growth of the IT sector. The changing trends of workers in the United States, shifting to new work, etc., affected the employers, who in turn had to look for remote employees and offshore workers. This led to the need to hire talent in countries like India where the talent pool was so large that it was feasible for the US firms to employ Indian talent, at reduced costs. The attrition rates in US IT companies have been a driver for the IT job market in India.

The challenges the IT sector will face in 2022 have been significantly impacted by the disruption caused by the pandemic such as challenge to digital adoption, bridging the gap between technology and skill set, finding the appropriate talent, attrition, cloud security, and so on. IT companies for the second year have played a key role in helping organizations to stabilize IT, reduce overheads, manage employee engagement, and meet changing customer demands.^[9]

Due to work from home (WfH)/remote location culture, proper team bonding has not been developed, and due to conversations mostly taking place digitally, communication has become a major hurdle faced by the organizations. This leads to a large number of resignations and bigger attrition rate across the IT industry. Further, WfH has also impacted the ability of new recruits to adapt to the new organization, as there is a lack of contact with the senior employees and, hence, mentoring has taken a back seat. As employees, have experienced the benefits of WfH culture, bringing back the culture of working from the office has now become a challenge. Many employees still want to continue the culture of WfH. It is also seen that there have been massive resignations in some of the bigger IT organizations when they announced the return of the office work culture.

Further, flexible HR policies will be necessary as a mutual win-win situation for the employer and employees in the IT industry. Some of the policies, already implemented by various IT companies in India are, for example, employees being given the option of WfH (wherever it is practical to do so); flexible timings for employees who are required to work from the office; or smaller co-shared offices at different locations in the city or at different places in different towns, so that employees can work from an office that is closer to their homes. In view of the flexibility demanded by the employees, it is becoming difficult for organizations to plan their future costs of infrastructure (that is, whether to have small offices at different locations or what size of office space is required).

As more and more organizations are moving towards the IoT, data streaming, the option of working remotely and cloud native apps, the problem of cyber security has risen exponentially. Organizations in the past two to three years have been affected by constant ransomware attack threats, data breaches and major IT outages that have affected the IT industry exponentially. 2022 is still a challenging year, as there is still a large talent pool to fill up for efficient and effective cybersecurity measures. It is also estimated that cyberattacks will be persistent in attacking small and medium scale businesses.

There is also a huge gap between the skills that the work demands and the skills that job applicants have. The education system in India still needs to be revamped and the present shortcomings affect the industries that seek highly skilled employees. Unemployment is high in India, but the fact is that many organizations are not able to find talent to fill the positions. Further, the COVID-19 pandemic has led many people to reevaluate their career paths; and due to increasing demand, top talents demand their own set of requirements, such as working in a hybrid model, or asking for full WfH policies, with additional perquisites. It is not always feasible for employers to meet these demands, thus, they have further fuelled the talent shortage and made it more challenging to acquire or retain incumbent talent pool.

More companies are opting for outsourcing due to the talent shortage or for purposes of cost reduction; but outsourcing has created some challenges like security threats, problems with data confidentiality, legal complications, cultural and time zone issues, etc.

3. IT Sector and Transfer Pricing

Transfer pricing (TP) provisions were introduced in the Income-tax Act back in 2001, which thus broadly aligned itself with the OECD guidance. Over two decades, transfer pricing law in India has undergone massive changes and seen various new issues emerging, while also resolving older ones.

The IT sector has been a key area for transfer pricing litigation since the inception of the transfer pricing regulations in India. The use of technology has been widespread globally and is used in all walks of life. The rapid increase in technology and its application in various businesses generates new and complex transfer pricing issues.

The Central Board of Direct Taxes^[10] (CBDT), to minimize the number of disputes and improve the quality of such disputes, has constantly been working on this by issuing various instructions and circulars. Alternative dispute resolutions have also been introduced.

The various IT sector services as understood from a functional perspective in transfer pricing both by the taxpayers and the tax department can be broadly classified as below:

9. See <https://www.crn.in/columns/challenges-that-it-leaders-must-look-out-for-in-2022/> (accessed 13 Oct. 2022).

10. The Central Board of Direct Taxes is a statutory authority functioning under the Central Board of Revenue Act, 1963.

- software development services;
- IT enabled services. These services include back-office operations, data processing, etc.;
- knowledge process outsourcing (KPO);
- business process outsourcing (BPO); and
- R&D services.

Transfer pricing for technology companies has its unique challenges. These companies can be large multinationals with a global presence, Indian multinational companies having international presence, and even start-ups that provide unique solutions and services globally.

Tax practitioners and companies around the world have been trying to grapple with the new and advanced business models due to rapidly changing technology. On a global scale, technology companies have unique and complicated services like SaaS, Platform as a Service (PaaS), IP valuations, etc. that may give rise to complex transfer pricing issues.

Technology companies need to factor in the various costs incurred, location of service centres, employee attrition rates, etc., to correctly determine the arm's length price of the international transactions (i.e., related-party transactions) as required by the income tax law (i.e., section 92 of the Income Tax Act 1961). Thus, appropriate transfer pricing policies need to be in place for avoiding unnecessary tax disputes. The below steps can be considered for mitigating the risk for the same:

- (1) appropriate delineation of the services/transactions, to understand the true nature of the services rendered. This will help the companies in their correct economic characterization and to identify comparable uncontrolled transactions/companies;
- (2) analysing the business model of the company and the MNE group as a whole;
- (3) analysing existing intercompany arrangements;
- (4) administration of employee locations, since remote work is a common practice in IT companies;
- (5) understanding where true value is created for the services provided;
- (6) documentation to be maintained to correctly demonstrate the economic substance of the international transaction; and
- (7) benchmarking analysis to select and apply the most appropriate method (MAM) and determine the ALP, as required by the law.

4. Indian IT Companies and Transfer Pricing

Indian IT companies are largely based on the outsourcing model and are usually captive service providers to their associated enterprises (AEs/group companies) or may provide services to third parties overseas. Different types of services are often outsourced by MNEs and are performed as per instructions of the MNE. Functional comparability, the markup on costs and turnover are usually the most disputed areas in this sector.

Meaning of IT/IteS in Indian income tax law

As per rule 10TA(m) of the Income-tax Rules 1962:^[11]

“software development services” means, –

- (i) business application software and information system development using known methods and existing software tools;
- (ii) support for existing systems;
- (iii) converting or translating computer languages;
- (iv) adding user functionality to application programmes;
- (v) debugging of systems;
- (vi) adaptation of existing software; or
- (vii) preparation of user documentation,

but does not include any research and development services whether or not in the nature of contract research and development services.

Further, as per Rule 10TA(e) of the Income-tax Rules 1962:

“information technology enabled services” means the following business process outsourcing services provided mainly with the assistance or use of information technology, namely: –

11. See <https://incometaxindia.gov.in/Pages/rules/income-tax-rules-1962.aspx> (accessed 13 Oct. 2022).

- (i) back office operations;
 - (ii) call centres or contact centre services;
 - (iii) data processing and data mining;
 - (iv) insurance claim processing;
 - (v) legal databases;
 - (vi) creation and maintenance of medical transcription excluding medical advice;
 - (vii) translation services;
 - (viii) payroll;
 - (ix) remote maintenance;
 - (x) revenue accounting;
 - (xi) support centres;
 - (xii) website services;
 - (xiii) data search integration and analysis;
 - (xiv) remote education excluding education content development; or
 - (xv) clinical database management services excluding clinical trials,
- but does not include any research and development services whether or not in the nature of contract research and development services;

It is generally seen from various tax jurisprudence and the information available from the public domain that in majority of cases the IT companies in India provide services to their AEs on a net cost or total cost-plus basis.

Further, since the IT-sector is a gamut of a wide variety of services, it is also witness to a high number of disputes with respect to the different type of services.

The IT sector in India has faced scrutiny in transfer pricing since its inception. Some major repetitive issues giving rise to disputes, include issues pertaining to comparability. The OECD Guidelines 2022^[12] provide the following steps to determine comparability (paragraph 1.36):

- characteristics of the services performed;
- functions performed by the parties (considering assets used and risks assumed);
- contractual terms;
- economic circumstances of the parties; and
- business strategies pursued by the parties.

Highly relevant comparability issues are, for instance, whether KPOs can be compared to BPOs or ITes can be compared with IT and software development services, etc. These are important as comparability determines the uncontrolled transactions/companies, which is critical in determining the correct arm's length price. It also needs to be evaluated whether exact comparability can be obtained wherever possible with respect to functions, assets and risks of both the taxpayer and the comparable companies. However, if the same cannot be obtained, then similar comparable uncontrolled transactions should be evaluated. In a recent case, the Karnataka High Court^[13] admitted the tax department's appeal that the Income Tax Appellate Tribunal (ITAT)^[14] was not right in seeking exact comparability.^[15] The Delhi High Court^[16] also held that even though annual reports of comparable companies may have similar terminologies, these companies may not necessarily be functionally comparable. The Court held that "the analysis at such a broad level, based upon the appearance of such similar terminologies, does not by itself make the functions similar in nature." Another important judgment in determining comparability was given by the Hon'ble Delhi High Court^[17] in *Agnity India*, wherein it held that a company that has a high brand value, as well as a high turnover cannot be compared to any ordinary company. The comparable company in question was Infosys Limited, a technology giant, engaged in diversified activities which include consulting, application design, development, re-engineering and maintenance, system

12. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2022), Primary Sources IBFD.

13. The High Court is the highest court of appellate jurisdiction in each state and union territory of India.

14. The Income Tax Appellate Tribunal (ITAT) is a quasi judicial institution, the second appellate authority under the direct taxes, the first independent forum in its appellate hierarchy and is also the ultimate fact finding authority.

15. See <https://www.taxsutra.com/news/hc-hear-revenues-appeal-selection-exact-comparables-vs-similar-comparables-under-tnmm-june> (accessed 13 Oct. 2022).

16. IN: Delhi High Court, 19 Sept. 2017, *Avenue Asia Advisors Pvt Limited* [TS-737-HC-2017(DEL)-TP], Case Law IBFD.

17. IN: Delhi High Court, 10 July 2013, *Agnity India Technologies Pvt Ltd* [TS-189-HC-2013(DEL)-TP], Case Law IBFD.

integration, package evaluation and implementation and business process management, etc., whereas the tested party undertook only contract software development services within the group and hence could not be compared based on functionality as well as high turnover.

The other issues of dispute include differences in the turnover, size and scale of operations between the tested party and various comparable uncontrolled companies identified by the tax department and the taxpayer; the treatment of various costs incurred; selection and application of the most appropriate method (MAM), etc.

Some filters commonly used while analysing the comparability of IT/ITeS companies include related-party transactions, extraordinary events/costs, export filter, inadequate financial or segment information, etc. Appropriate segment information is crucial in this sector, as a company that may be engaged into KPO/BPO services may not be comparable with one that also provides software development services along with KPO/BPO services, unless complete segmental information is available.

Availability of segmental information is also important with regard to comparability. However, mere availability of segmental information may not be enough. It may sometimes be necessary for both the taxpayer and the transfer pricing officer to analyse the segmental information and also give credence to other information, e.g. the notes to accounts, and evaluate whether the segmental information is reasonable and can be used.

While differentiating KPO and BPO services, a special bench ruling of the Mumbai ITAT^[18] held that KPO is an evolution of BPO and is an upward shift in the BPO industry. This may make it difficult to classify certain companies as strictly BPO or KPO and hence no bifurcation of ITeS companies would be necessary. This Ruling suggested that:

The principal functions performed by the tested party should be identified and the same can be compared with the principal functions performed by the entities already selected to find out the relatively equal degree of comparability. If it is possible by this exercise to determine that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated. The examination of controlled transactions ordinarily should be based on the transaction actually undertaken by the AE and the actual transaction should not be disregarded or substituted by other transactions.

Contrary to the above judgment, the Hon'ble Delhi High Court^[19] held that a BPO does not involve advanced skills while a KPO does involve use of advanced skills for providing various services. The term "KPO" indicates an ITeS provider providing a completely different nature of services than any BPO service provider. A KPO would also be functionally different from BPOs, with respect to functions performed, type of resources employed, business model, etc.

Turnover filter is also an extremely important filter that determines the volume of a company's operation. A significantly high or low turnover may not be comparable with that of the tested party. Generally, a range of ten times the turnover of the tested party and one-tenth of its turnover is considered reasonable for functional comparability. This has been upheld by the Pune ITAT^[20] in a ruling stating that:

Turnover filter is a relevant criteria for determining of ALP of international transactions entered into by assessee and, thus, so far as range of turnover filter is concerned, picking up comparable cases with *10 times below and 10 times higher* turnover of assessee, is appropriate for companies... [Emphasis added.]

The Hon'ble Bombay High Court in the case of *CIT v. Pentair Water Pvt.Ltd.*, by order dated 16/09/2015 in ITA No. 18/2015, upheld rejection of companies having a high turnover, holding that turnover is a relevant factor in considering comparability of companies. The Court held that "[w]hile making the selection of comparables, the turnover filter, in our opinion, has to be the basis for selection. A company having turnover of Rs.11 crores cannot be compared with a company which is having turnover of Rs.260 crores which is more than 23 times the turnover of the assessee. This company cannot be regarded to be in equal size to the assessee."

Other adjustments include working capital adjustments, risk adjustments, location savings, etc.

Another important area of distinction in the IT sector is classifying and distinguishing software development companies from ITeS companies. In a Pune Tribunal^[21] ruling it was held that ITeS companies cannot be compared with software development companies as they are functionally very different and also require different skill sets.

Over the years, India has seen a high number of litigations in the IT sector, wherein MNEs were subjected to transfer pricing additions on account of lower price/margins earned by the Indian group companies, under the assumption that there was, thus, transfer of profits to overseas group companies. However, the government has modified the transfer pricing regulations to lessen the long-drawn litigations and penalties. Various alternate dispute resolution mechanisms have been introduced such as:

- advance pricing agreements;
- mutual agreement procedure; and
- safe harbour rules.

18. IN: ITAT Mumbai, 14 Dec. 2012, *Maersk Global Centres (India) Pvt. Ltd. v/s. ACIT* (ITA No.7466/Mum/2012), Case Law IBFD.

19. IN: Delhi High Court, 10 Aug. 2015, *Rampgreen Solutions Pvt Ltd vs CIT* 377 ITR 533.

20. IN: ITAT Pune, 9 Sept. 2019, *Tetra Pak India (P.) Ltd v. ACIT* [2019] 108 taxmann.com 208 (Pune - Trib.).

21. IN: ITAT Pune, 31 Jan. 2017, *TIBCO Software India (P.) Ltd v. DCIT* [2015] 56 taxmann.com 91, Case Law IBFD.

Advance pricing agreement (APA) – The APA rules aim to provide certainty and relief to MNEs and reduce transfer pricing litigations. The APA program in India has seen immense success over the years. In the IT sector, being a large contributor to India's GDP, a huge number of APAs have been filed and signed. The IT sector APAs cover a large variety of transactions, i.e., provision of IT services, ITeS services, engineering design services, contract R&D, etc. Before concluding APAs, a detailed functional, asset and risk (FAR) analysis of the company is carried out, including functions carried out, the size and skill set of employees within the group; and the tax department makes site visits to understand the actual conduct of business. Up to FY 2017-18, around 145 APAs were concluded in the services sector, mainly for the IT/ITeS industry. In FY 2018-19, a total of 164 international transactions had been covered under the 41 unilateral APAs entered. 11 transactions relating to the provision of IT services and 12 relating to the provision of ITeS were signed among the 41 agreements.

As per the latest reports, around 421 total APAs have been concluded and in most years it can be seen that around 30% of the total APAs for a given year were requested for the IT/ITeS sector.

Mutual agreement procedure (MAP) – The MAP is an alternative mechanism for the resolution of international tax and transfer pricing disputes. MAP provisions are invoked by taxpayers when they are of the opinion that tax is levied by tax authorities that is not in line with the double taxation avoidance agreement/tax treaty entered by India with another country.

The objective of the MAP process is to:

- negotiate an acceptable arm's length price by the tax authorities of both contracting states; and
- to avoid economic double taxation for the taxpayers.

Safe harbour rules (SHR) – Safe harbour rules were issued by the CBDT in 2013 under which the tax authorities will accept the transfer price declared by the taxpayer. Taxpayers opting for the SHR need to file the return of income for the year on or before the date of furnishing the prescribed Form 3CEFA for opting for the SHR. These Rules provide the procedure for adopting a safe harbour, the transfer price to be adopted, the compliance procedures upon adoption of the prescribed safe harbour and circumstances in which a safe harbour adopted may be held to be invalid. The latest SHR applicable to IT sector is shown in Table 1.

Table 1 – Safe harbour rules applicable to IT sector

Eligible international transaction	Safe harbour rule
Provision of <i>software development services/ITeS</i>	Operating profit margin to operating expense
- where the aggregate value of such transactions \leq INR 100 crores (USD approx. 12.5 mn)	$\geq 17\%$
- where the aggregate value of such transactions $>$ INR 100 crores but less than INR 200 crores (USD approx. 12.5 mn to 25 mn)	$\geq 18\%$
Provision of <i>contract research and development services</i> wholly or partly relating to software development, where the value of the international transaction \leq INR 200 crores (USD approx. 25 mn)	$\geq 24\%$
Provision of <i>knowledge process outsourcing services</i> where the value of the international transaction does not exceed INR 200 crores (USD approx. 25 mn) and the employee cost in relation to operating expense	
- is at least 60%	$\geq 24\%$
- is 40% or more but less than 60%	$\geq 21\%$
- does not exceed 40%	$\geq 18\%$

The above provisions for safe harbour law are contained in section 92CB of the Income Tax Act 1961 and rule 10TD of the Income Tax Rules 1962

5. Impact of the Pandemic on the IT Sector

The IT sector was affected in the beginning of the pandemic when many employees were laid off, as demand fell and strict lockdowns were imposed. Major costs incurred by this sector, like all other sectors, due to the pandemic involved setting up IT infrastructure costs, i.e., work from home (WfH) costs, security costs to prevent data leakage for their own employees, etc. However, due to the immense surge in demand for remote-working technology, social media and digital interactions, there was huge innovation in the IT sector, which was hastened due to lockdowns, etc.; thus, this sector saw a quick recovery and increase in profits.

Technology giants reported enormous profits at the start of the pandemic as a large part of the population became more technology dependent. For instance, companies like Apple, Microsoft and Google saw their profits double. Huge demand for online services because of the sudden onset of the pandemic led to the rise in profits of these tech companies.

Similarly, in India, while most sectors suffered huge losses, IT companies reported a surge in their profitability. This can be attributed to the growing need for digital transformation as more and more companies are going permanently online, especially in the retail sector, banking services, various technology based companies, healthcare and education sectors, etc.

Fitch ratings Report^[22] in October 2020 predicted that the pandemic will accelerate digital IT spend and the pandemic-related impact is likely to be only moderate and short term, as customers focus on transforming their businesses digitally, moving services and work platforms online, and minimise spending on legacy services.

This Report added that it expected that the Indian industry to continue to take advantage of its low-cost operations and maintain its strong foothold in the global IT landscape.

However, even though companies in this sector benefitted largely during the initial days of the pandemic, they experienced a steady decline in profits and margins as the pandemic progressed. One of the largest tech companies, Google's parent company Alphabet, saw its slowest quarterly revenue growth as of April 2022 since 2020: an indication that the large demand for its services during the pandemic has begun to fade. Other large technology companies also have reported a downward trend. This is reflected in India where major technology companies like Tata Consultancy Services and Infosys Limited have reported lower margins in FY 2022 when compared with the pandemic boom in FY 2021.

A report by Crisil in July 2022^[23] stated:

The information technology services sector will see a sharp fall in revenue growth to 12-13 per cent in FY23 from 19 per cent in FY22.

However, the current depreciation in the rupee, strong demand for new age technologies like artificial intelligence, cloud computing and Internet of Things will help the over USD 220-billion sector maintain a double digit growth.

6. COVID-19 and Transfer Pricing

The pandemic has brought about many changes in the way a company functions. Such changes are also clearly visible across the IT and ITeS sector. IT and ITeS companies quickly adapted to the new normal, i.e. developing an appropriate IT infrastructure to be able to work from home and evaluating the impact of the crisis situations to modify their business models wherever necessary.

As discussed above, these changes should be appropriately delineated to understand the true impact of the pandemic. Such delineation would involve:

- (1) evaluating the unusual and extra costs arising due to the pandemic, such as cancellation of contracts, supply costs, employee costs etc., and how such costs are to be allocated;
- (2) evaluating the costs of underutilized resources in various BPO and KPO centers and their impact;
- (3) evaluating digitization / technology related costs;
- (4) evaluating risks borne by various entities within an MNE group;
- (5) undertake a detailed FAR analysis to understand and evaluate the changes necessary as per the market circumstances;
- (6) make capacity adjustments due to the sudden nature of the pandemic wherever necessary;
- (7) review the existing intercompany arrangements and check whether any modifications to the same are required; and
- (8) evaluate the benchmarking methods for the international transactions undertaken and check whether any modifications are required.

Specific issues that need to be considered due to COVID-19 with respect to transfer pricing are discussed in section 7.-10.

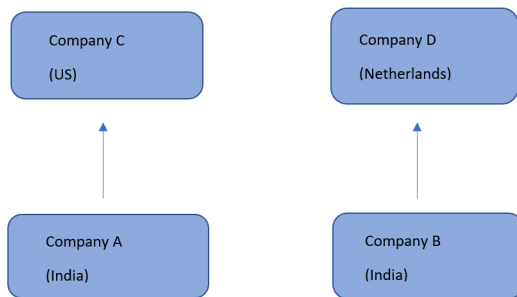
22. See <https://www.fitchratings.com/research/corporate-finance/spotlight-indian-it-services-industry-06-10-2020> (accessed 13 Oct. 2022).

23. See <https://www.crisil.com/en/home/newsroom/press-releases/2022/07/it-services-to-log-double-digit-revenue-growth-this-fiscal-too.html> (accessed 13 Oct. 2022).

7. Comparability adjustments

As a result of the pandemic, some companies that were comparable pre-pandemic may no longer be so. See figure 2.

Figure 2 – Comparable companies that may become not comparable due to the pandemic



For instance, prior to the pandemic, both Company A and Company B provided similar captive services to third parties respectively. However, as the United States was more adversely affected by the pandemic than the Netherlands, Company A and B no longer remain comparable. To still consider the companies as comparable, certain comparability adjustments may be required.

8. Use of Multiple Year data

Multiple year data as prescribed by rule 10CA(1) of the Income Tax Rules, 1962 may also not be feasible as pre-pandemic years could be more profitable than the COVID-19 period, which would mean they are no longer comparable.

The OECD Guidelines point out that historical data cannot be relied on in correctly determining the arm's length price in case of certain transactions and information of comparable uncontrolled transactions undertaken in the same period is more reliable.

9. Renegotiation of APAs

Companies that opted for SHR in earlier years may find it difficult to meet the criteria in the COVID-19 years. Therefore, such companies may choose to opt out of the same for the relevant years.

Companies that have opted for an APA need to evaluate the effect of the pandemic on such an APA and whether there would be a need to change or modify the agreement, considering the current economic conditions.

In its 2020 Guidance on the transfer pricing implications of the COVID-19 pandemic^[24] (see section 10.), the OECD suggests that taxpayers whose APAs are affected by the pandemic should determine the impact and take corrective steps.

Various negotiation options are also suggested at para. 109 of this Guidance:

For example, consideration could be given to agreeing a short period APA covering the period affected by the COVID-19 pandemic and a separate APA covering the post-COVID period. Another solution could be to conclude the APA for the whole period (e.g. APA period of 2020-2024) with a condition that the relevant impacts of the COVID-19 pandemic will be analysed and reported annually once they are known, and retrospective amendments to the APA made accordingly, when appropriate. Another solution could be to extend the period of the APA to mitigate the short term effect of the pandemic, depending on the magnitude and the length of such effect. Additionally, the use of a cumulative or term test throughout the APA period could be given consideration. In this context, it is important that taxpayers be transparent and disclose all relevant information concerning the impact of the COVID-19 pandemic on the covered transactions in a timely manner.

While many established MNEs struggled to retain employees and business as the pandemic spread, India and the rest of the world saw a boom in various technology start-ups aimed at providing specific services that benefit users during the pandemic.

These companies provided essential services in times of the pandemic. They mostly comprise healthcare technology (healthtech), education technology (edtech) and financial technology (fintech). Such enterprises are focused on introducing technology in essential services. They have grown rapidly over the period of the pandemic, and some have shown potential for successful business models.

Transfer pricing for these companies needs to be evaluated right from the investment phase to implementation. Some critical issues that may need to be evaluated include the detailed business model, capital and ownership structure, types of services, cost allocations, etc.

24. See OECD, *Guidance on the transfer pricing implications of the COVID-19 pandemic* (OECD, 2020), available at <https://www.oecd.org/coronavirus/policy-responses/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic-731a59b0> (accessed 4 Nov. 2022).

Going forward, these types of companies will be more common with hybrid business models. It will be necessary to maintain appropriate and robust documentation to demonstrate the correct arm's length price, as the onus for the same will remain with the taxpayer.

10. OECD's Guidance on Transfer Pricing Implications of COVID-19

In response to the pandemic, the OECD published guidance on the transfer pricing implications of COVID-19 in December 2020 (the Guidance),^[25] addressing the various difficulties faced in determining the arm's length price, in the comparability analysis, allocation of costs, treatment of losses, government regulated changes etc.

The Guidance deals with:

- the comparability analysis;
- extraordinary costs; and
- APAs.

The Guidance also discusses in detail the factors to be kept in mind while undertaking a comparability analysis. It points out that historical data cannot be relied on in correctly determining the arm's length price in case of certain transactions, and that contemporaneous information of comparable uncontrolled transactions is more relevant. This also reflects how independent parties have responded to the crisis. The Guidance also lists sources from which contemporaneous data may be obtained for the comparability analysis.

The Guidance considers the various challenges faced by taxpayers due to the pandemic, and offers certain pragmatic approaches that can be adopted by revenue authorities to minimize disputes when taxpayers make efforts in good faith to determine arm's length prices, despite the information deficiencies associated with the pandemic. These approaches are discussed below.

(1) Allowing reasonable commercial judgement combined with contemporaneous information to set a reasonable estimate of the arm's length price

The Guidance states that both taxpayers and tax administrations should recognize that delayed availability of contemporaneous data and determining the arm's length price requires flexibility and exercise of good judgement. It encourages taxpayers to undertake reasonable and appropriate due diligence to evaluate effects of the COVID-19 pandemic and the consequent impact on transfer prices. It states that "MNE groups should document the best available market evidence currently available, which may be in the form of internal comparables, external comparables, or other relevant evidence of the economic impact of the COVID-19".

(2) Where feasible, allow for an arm's length outcome testing approach

The Guidance suggests that out of the two approaches described in the OECD Guidelines, i.e. the "price-setting," approach that uses historical data updated to reflect any changes in economic conditions and the "outcome-testing" approach that allows information that becomes available after the close of the taxable year to determine the arm's length conditions, wherever possible, the latter approach should be used, even if on a temporary basis.

(3) Use of more than one transfer pricing method

The Guidance also recognizes the possibility of applying more than one transfer pricing method considering the specific challenges of the pandemic and the guidance given in the OECD Guidelines.

Additionally, the Guidance discourages the use of data from any prior crisis for the comparability analysis (e.g. the financial crisis of 2008/2009) because each situation presents itself with unique and unprecedented challenges and hence a transfer pricing analysis should be carried out by evaluating the actual prevalent economic circumstances.

11. Way Forward – Challenges and Opportunities

Transfer pricing requires an analysis of the actual conduct of business and, thus, is based on the economic substance of the transaction. The need for such an in-depth analysis is accentuated during an economic crisis, like the one brought about by the pandemic. The maintenance of pertinent robust documentation to correctly demonstrate the impact of the pandemic; various measures taken to mitigate this impact; changes introduced in the various intercompany arrangements, etc. cannot be emphasized too much. Further, short-term as well as long-term impacts of the pandemic will need to be evaluated.

The onus is on the taxpayer to correctly demonstrate the economic fallout of the pandemic and the economic adjustments required to be made to benchmark the controlled transactions. All this will help taxpayers to mitigate litigation risks, reduce disputes and demonstrate their transparency and trustworthiness.

²⁵. Id.

Though first the pandemic turned out to be a boost for the business of IT companies, when the effects of COVID-19 became milder and employees started returning to the office, the demand for technology began to go down. IT companies need to constantly evolve to meet the challenges of the changing economic environment.

Benchmarking of various transactions from a transfer pricing perspective, during the COVID-19 period will prove to be a challenge for IT companies. Especially the pre- and post-pandemic comparable companies may be different and taxpayers will have to be aware of the comparability adjustments that may be required to be made. The arm's length standard (ALS), which is the heart of transfer pricing law in India and globally, will also be tested, as an economic crisis can accentuate the defects of any standard, especially with regard to tax matters.

The arm's length standard is a universal standard, which has weathered many an economic crisis. The ALS foundation lies in performing a correct comparable analysis, which also gives it the flexibility to account for drastic changes in the economic scenario by adopting a pragmatic approach to the selection of comparable uncontrolled data, and making economic adjustments wherever required.

Both the taxpayer and the revenue authorities would also need to be fair in their approach to apply the ALS in an equitable manner, to resolve the issues that may arise during the TP audits pertaining to the pandemic period and the later period.



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