



# Navigating the Headwinds: Mitigating Contention in India-US Business Engagement

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April 2014

- Policy Report #1 Deconstructing India's Preferential Market Access (PMA) Policy
- Policy Report #2 India's Investment Climate: Addressing Concerns about Tax Policy
- Policy Report #3 US Immigration Reform: Revisiting the Approach to Skilled Visa Provisions



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Indian Council for Research on International Economic Relations

## **ICRIER Wadhvani Programme of Research Studies on India-US Relations and Policy Issues**

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## FOREWORD

The ICRIER Wadhvani Chair in India-US Policy Studies, established in 2011 with the generous funding support of the Wadhvani Foundation, has been conducting research on key areas of India-US relations in order to promote a strategic partnership between the two nations.

Even as India-US trade (in both goods and services) has reached the \$100 billion mark, the past year has seen the emergence of a number of contentious issues which have adversely impacted the climate for bilateral trade and investment.

Against this backdrop, the ICRIER Wadhvani Chair has undertaken a number of separate policy studies under its “Navigating the Headwinds” series to understand, clarify and mitigate issues in India-US business engagement.

ICRIER is happy to present the three reports contained in this volume, namely, “Deconstructing India’s Preferential Market Access (PMA) Policy”, “India’s Investment Climate: Addressing Concerns about Tax Policy” and “US Immigration Reform: Revisiting the Approach to Skilled Visa Provisions”.

Given the timeliness of these reports and the initial feedback which ICRIER has received, we are confident that these important research papers will help significantly to improve the India-US business environment.

In the coming months, the ICRIER Wadhvani Chair will continue to focus its attention on India-US economic issues through further reports and conferences that will assess India’s untapped potential as a destination for US FDI.

I would like to express my appreciation for Chair Professor H.K. Singh’s efforts in directing these research studies and compliment the authors, R.R. Singh, Neetika Kaushal, Mansi Kedia and Aman R Khanna for the high quality of these reports.

**Rajat Kathuria**  
Director & Chief Executive  
ICRIER

April 15, 2014



# Policy Report #1

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## Deconstructing India's Preferential Market Access (PMA) Policy

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# Policy Report #1

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## INTRODUCTION

Indian policy makers are once again dealing with the ire of foreign investors, this time over the implications of the Preferential Market Access (PMA) policy notified by the Government of India in February 2012. PMA<sup>1</sup> mandated a phased increase in the domestic value addition of electronic goods. The notification included products that have security implications and must, therefore, be procured from a domestic manufacturer to the extent prescribed. The policy was made applicable to all government ministries and their agencies except defence, but excluded commercial sales.<sup>2</sup>

PMA quickly became a matter of contention, particularly between investors from the United States and the Indian government. The US-India Business Council (USIBC), on behalf of its 350 member companies, urged the Indian government to review the policy. PMA was also extensively criticised by different quarters, including foreign companies and industry associations<sup>3</sup> in both India and the US.

USIBC contested the possibility of bringing private companies under the PMA umbrella and warned that a mandated approach to foreign investment would only drive away investments from India. Technology groups from countries such as Australia, Canada, Japan,<sup>4</sup> South Korea, and Taiwan had also raised concerns over the “flawed policy”, which they claimed disregards market-based principles of manufacturing growth.

Several other instances in the recent past have reinforced concerns that India is turning protectionist and renegeing on its international commitments. For instance, the Supreme Court’s judgment in the Glivec patent case and the imposition of retrospective capital gains tax on telecom firm Vodafone have dented India’s image among foreign investors.

The PMA policy is driven by two broad objectives: a) India’s national security concerns; and b) preserving and indeed promoting domestic manufacturing, especially in the information and communication technology (ICT) sector. There is widespread belief among decision making bodies that the growing pervasiveness of IT and electronics has increased India’s vulnerability to cyber attacks, which are now a reality in

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1 [http://deity.gov.in/sites/upload\\_files/dit/files/Preferential\\_Market\\_Access\\_Notification\\_1232012.pdf](http://deity.gov.in/sites/upload_files/dit/files/Preferential_Market_Access_Notification_1232012.pdf)

2 [http://eprocure.gov.in/cppp/sites/default/files/gos/Preferential\\_Market\\_Access\\_Notification\\_1232012.pdf](http://eprocure.gov.in/cppp/sites/default/files/gos/Preferential_Market_Access_Notification_1232012.pdf)

3 Other associations include American Chamber of Commerce in India, Information Technology Industry Council, ITI, etc.

4 Japan Information Technology Service Industry Association.

India.<sup>5</sup> The country has suffered such attacks on its critical infrastructure. Besides, India's decision to join the WTO's Information Technology Agreement I (ITA I) in March 1997,<sup>6</sup> has been criticised for damaging its domestic manufacturing capabilities by permitting duty free imports under 217 tariff lines.<sup>7</sup> Over a period of time, this has resulted in inverted duty structures, which add to India's existing cost disadvantages. Boosting domestic manufacturing would, the argument is made, also help India reduce its sizable balance of payments deficit in the electronics sector.

In response to concerns expressed by US and other foreign investors on the application of PMA to the private sector, the Indian Prime Minister's Office (PMO) decided in mid-July 2013 to review the policy. A PMO statement put on hold all aspects related to private sector procurement and called for an assessment of manufacturing capability in products that qualify for domestic value addition. The PMO further decided that no notifications on PMA in the private sector would be issued until the review is complete.<sup>8</sup> In December 2013, the Indian cabinet approved a revised PMA, completely exempting the private sector from compulsory domestic sourcing of technology products included as security sensitive under the policy. This policy will be valid for a period of ten years.

This paper is intended to provide an understanding of PMA as a policy instrument, its implications for foreign investments and its relevance for the growth of manufacturing in India. Section II outlines the provisions of the policy and addresses concerns raised by stakeholders. Section III explains the concept of preferential market access along with illustrations of how this policy has been adopted in other countries. Finally, Section IV evaluates the effectiveness of the policy to achieve stated objectives. Section V offers conclusions and recommendations. The analysis and arguments presented in the paper are based on information from secondary data sources and stakeholder interactions.<sup>9</sup>

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5 Telecom Live, September 2013, "Huawei attacks BSNL Network".

6 [http://commerce.nic.in/wtoit\\_2.htm](http://commerce.nic.in/wtoit_2.htm)

7 Murali Kallummal, 2012, "Process of Trade Liberalization under the Information Technology Agreement (ITA), Centre for WTO Studies, IIFT, CWS Working Paper no: CWS/WP/200/3.

8 <http://pmindia.nic.in/press-details.php?nodeid=1660>

9 Stakeholders include representatives from DeitY, DoT, and Industry Associations.

## INDIA'S PMA POLICY AND WHERE IT STANDS TODAY

Market access is a measure of a country's openness to foreign goods and services. Preferential market access tools are used by countries to control the import of products and encourage domestic manufacturing. PMA can also be seen as the practice of introducing policies that are designed to favour domestic firms. Several countries have employed preferential market access policies to bolster domestic manufacturing, which are also referred to as "localisation barriers to trade". The five different types of such localisation barriers are linked to production or sales, intellectual property (IP) or technology transfer, investments, standards or certification, or to data localisation.<sup>10</sup> In the case of electronics, localisation is also seen as an instrument for security. Recent examples of security breaches<sup>11</sup> have led countries to become conservative in IT openness.

India's localisation barriers under the PMA are production linked through local content requirements, stipulating that final products should contain a certain percentage of local value addition, but does not provide for any price preferences or quality. Similar policy provisions in India include the National Solar Mission, which mandates solar energy producers to procure 50 per cent of their requirements from domestic solar cell manufacturers. This provision is applicable to projects using crystalline silicon technology, which is the technology most domestic Indian manufacturers employ, in order to qualify for subsidies.<sup>12,13</sup> FDI regulations on multi-brand retail<sup>14</sup> also require foreign firms to comply with local sourcing conditions.

India's PMA policy provides preference to domestically manufactured electronics products under the following terms:<sup>15</sup>

*"The Government has ... laid down the following policy for providing preference to domestically manufactured electronic products, in procurement of those electronic products which have **security** implications for the coun-*

10 Stephen Ezell, 2013, "Forced Localization Policies Threaten Global Trade in Innovative Industries".

11 Washington State Administrative Office of the Courts (2013), Internal Site of the Federal Reserve (2013), NASA (2012).

12 The Committee of Energy and Commerce Memorandum, United States, June 2013.

13 Developers using thin film technology can be sourced from anywhere. The US challenged this barrier at the World Trade Organization (WTO) on February 6, 2013. Japan and Australia asked to join the dispute.

14 Press Note 5, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India.

15 Using the version: [http://deity.gov.in/sites/upload\\_files/dit/files/Preferential\\_Market\\_Access\\_Notification\\_1232012.pdf](http://deity.gov.in/sites/upload_files/dit/files/Preferential_Market_Access_Notification_1232012.pdf)

try and in **Government procurement** for its own use and **not with a view to commercial resale** or with a view to use in the **production of goods for commercial sale.**”

The list of electronic products is to be notified by concerned ministries and their departments, and agencies are required to procure those products from a domestic manufacturer to the extent prescribed in these notifications. Domestic manufacturers include all companies, Indian or foreign, engaged in manufacturing that are registered in India. The definition includes contract manufacturers, but excludes traders. The policy stipulates that, within the first year of its implementation, 25 per cent of value addition must be done domestically in India.

The Department of Telecommunications (DoT) and the Department of Electronics and Information Technology (DeitY) proposed a list of sensitive telecom and communication equipment and other generic equipment respectively. In January 2013, a draft list of 14 products (details in Table 1 below), along with a schedule for domestic value addition requirements,<sup>16</sup> was circulated by DoT. The Department of Electronics and Informational Technology (DeitY) has similarly issued guidelines to provide preference to domestically manufactured electronic products in government procurement, the latest version of which was issued in June 2013.<sup>17</sup> The notification stated that all products would not be taken up simultaneously, and products with high value in terms of procurement in government and government agencies would be identified for notification on a priority basis. The indicative list of 18 such items can be seen in Table 2 below.

Table 1: List of Security Sensitive Items Identified for Preferential Market Access (as on Jan 2013)

S. No.	Product Description
1	Encryption/UTM platforms (TDM and IP)
2	SIM Card Operating System (OS) and Personalisation activities
3	Core/Edge/Access Routers and Ethernet switches (L2 and L3) up to 1 Tbps capacity
4	Wireless/Wireline PABXs
5	SDH/Carrier-Ethernet/Packet Optical Transport equipment and Digital Cross connects
6	DWDM/CWDM systems
7	GPON equipment
8	GSM 2G based BSS Systems including BTS and BSC
9	3G based wireless Access Systems including Media gateway, media server, GGSN, SGSN, Node B , RNC, HLR, SMSC & other subsystems
10	LTE based broadband wireless access systems (eNodeB, EPC etc.)
11	Wi-Fi based broadband wireless systems (Access Point, Aggregation Block, Core Block etc.)
12	Microwave Radio systems (SDH/IP/Hybrid)
13	Repeaters (RF/RF-over-Optical), IBS, and Distributed Antenna system
14	Network Management systems

Source: DoT

16 <http://www.dot.gov.in/sites/default/files/Draft%20List%20of%20Security%20Sensitive%20Telecom%20Products%20for%20PMA%20by%20Govt%20Licensee-consultation%20dated17-01-2013.pdf>

17 File No. 8(78)/2010-IPHW, Ministry of Communications and Information Technology, DeitY.

Table 2: Indicative list of products for PMA issued by department of electronics and informational technology (DeitY) in June 2013

S. No.	Products
1	Notebooks and netbooks
2	Tablets
3	Desktops
4	Servers
5	Printers
6	Keyboards
7	Monitors
8	Storage USBs, Memory Cards
9	CCTV and Surveillance Cameras
10	ATMs
11	Photocopiers
12	Scanners
13	Faxes
14	Smart Cards
15	Mobile Handsets
16	Handheld Terminals
17	PC Projector
18	POS based devices

Source: DeitY

Separate notifications have already been issued for LED products,<sup>18</sup> tablets,<sup>19</sup> laptops,<sup>20</sup> desktop personal computers<sup>21</sup> and smart cards.<sup>22</sup> As the entire policy is under review, the proposed list of products for telecom and electronics might also undergo change.

The PMA policy provisions in their current form comply with India's international commitments. As an observer to the WTO's Agreement on Government Procurement<sup>23</sup> (GPA), India is not legally bound to comply with GPA provisions. Parties to the agreement are mostly developed countries with mature industries and domestic manufacturing. India, among the group of observer countries, is still struggling with several domestic challenges that need government support and phased-out liberalisation. However, as a signatory to the WTO, India cannot extend the policy to the private sector, except for core security interests.

18 [http://deity.gov.in/sites/upload\\_files/dit/files/PMA%20Notification%20for%20LED%20.pdf](http://deity.gov.in/sites/upload_files/dit/files/PMA%20Notification%20for%20LED%20.pdf)

19 [http://deity.gov.in/sites/upload\\_files/dit/files/PMA%20Tablet%20PC.pdf](http://deity.gov.in/sites/upload_files/dit/files/PMA%20Tablet%20PC.pdf)

20 [http://deity.gov.in/sites/upload\\_files/dit/files/PMA%20Laptop%20PC.pdf](http://deity.gov.in/sites/upload_files/dit/files/PMA%20Laptop%20PC.pdf)

21 [http://deity.gov.in/sites/upload\\_files/dit/files/pma\\_pc\\_print.pdf](http://deity.gov.in/sites/upload_files/dit/files/pma_pc_print.pdf)

22 [http://deity.gov.in/sites/upload\\_files/dit/files/PMA%20Notification%20for%20Smart%20Cards\(1\).pdf](http://deity.gov.in/sites/upload_files/dit/files/PMA%20Notification%20for%20Smart%20Cards(1).pdf)

23 The **Agreement on Government Procurement (GPA)** is a plurilateral agreement under the auspices of the World Trade Organization (WTO) that entered into force in 1996. It regulates government procurement of goods and services by public authorities of the parties to the agreement, based on the principles of openness, transparency and non-discrimination. The GPA was negotiated in parallel with the Uruguay Round in 1994, and entered into force on January 1, 1996.

As part of its continuing efforts to reform and liberalise, India has been providing greater and non-discriminatory market access to foreign firms. India's approach to reform has been dominated by a gradualist model,<sup>24</sup> that in the context of India's political economy has served it well. However, India acknowledges the need for fair practices, and provides judicial recourse against any policy initiative that does not comply with its legal obligations, both domestic and international. This was further strengthened with India's accession to the WTO in 1995, and its signing several plurilateral, regional and bilateral agreements thereafter, that required adoption of global standards and libertarian practices. This has enabled the establishment of an institutional framework that provides for a consultative process to decision making.

In the case of government procurement under PMA, India is within its rights to provide preferential access to domestic producers.

Among other issues, the US believes that India's PMA policy will encourage protectionist measures in other countries, reducing global competition and open markets. The spill over impact of India's PMA to other countries, while possible, cannot be a reason for India to ignore policies that serve national interest. Moreover, this claim needs to be substantiated based on evidence from a longitudinal study. Evaluation will establish if their actual impact is commensurate to the perceived level of being restrictive and an instrument of economic nationalism. India's role as a globalised emerging economy has brought the country onto the centre stage of economic and political decision making. As one of the leading G20 countries among emerging economies, India's policies are now carefully scrutinised by the rest of the world. As a potential market for most developed countries, though policies like PMA are criticized, it fits in well with India's overall development strategy and is similar indeed with that in several other countries. This argument is further strengthened in the next section.

However, India's policies are hardly an anomaly in the post-2008 crisis period. "*The gated globe*"<sup>25</sup> is an emerging trend among countries across the world that want to enjoy the benefits of globalisation, but simultaneously insulate themselves from volatile capital flows and rising imports. Although PMA is principally a protectionist policy instrument, used by several countries, India's PMA policy is more benign and less distortionary than it appears. The policy does not allow for price preferences to domestic manufacturers, as in the case of other countries,<sup>26</sup> and is restricted to government procurement. The notification explicitly states that technically qualified domestic manufacturers are eligible only if they match the lowest bid (L1); in case domestic manufacturers cannot match the lowest price, or are not available at all, the entire contract can be awarded to a foreign company. With demand in the electronics hardware industry projected to increase at a CAGR of 24.4 per cent until 2020,<sup>27</sup> and with the share of the private sector being significant,<sup>28</sup> the preference provided to domestic manufacturers is unlikely to create major distortions or undermine competition significantly. It would, however, provide technically qualified domestic manufacturers access to an otherwise restricted market. However, industry representatives fear that the revised PMA policy, that excludes the private sector, announced by the Government in December 2013, may jeopardise investments

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24 Montek S. Ahluwalia, 2002, "Economic Reforms in India since 1991: Has Gradualism Worked?"

25 "The Gated Globe", The Economist, October 2013.

26 Refer "Buy America" policy discussed in Section II.

27 DeitY, 2012, Demand for Electronics Hardware in India estimated to increase from USD69.6 billion in 2011-12 to USD400 billion in 2019-20.

28 According to government sources, the share of government procurement in ICT is not more than 50 percent. This is based on stakeholder interviews conducted as a part of this research.

in the private sector, as it suggests a withdrawal from the “big push” reforms towards domestic electronic manufacturing.<sup>29</sup>

Both telecom and electronics exhibit characteristics of networked industries, which imply high switching costs, problems of lock-in, increasing returns to scale in production, and decreasing average cost of production. High-technology procurement in India is driven by a few large international companies, in a decidedly oligopolistic market. Given their dominance, domestic manufacturers need support to gain access; PMA will thus only create an opening and not distort global manufacturing for IT majors<sup>30,31</sup>.

As a policy, PMA holds the potential to provide a way to increase the capabilities of local manufacturers, and encourage foreign direct investments in India.<sup>32</sup> According to the Indian Telecom Equipment Manufacturing Association (TEMA), implementing PMA is likely to boost FDI, since large telecom companies will focus on domestic manufacturing. Therefore the argument suggesting absolute protection is invalid, and foreign companies remain eligible to participate in manufacturing via the FDI regime and also through exports.

The revised PMA does not include domestic manufacturing requirements, percentage based or otherwise, for security-related products in the private sector. The PMO has officially communicated that the policy suggests a re-look at alternative approaches to handle security-related products, including certifications and the development of domestic testing capabilities.<sup>33</sup>

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29 <http://economictimes.indiatimes.com/news/politics-and-nation/government-exempts-private-sector-from-the-revised-pma-policy/articleshow/27480268.cms>

30 M. F. Farooqui, Secretary of the Department of Telecommunications (DoT), during an industry event stated that multinational companies had much to benefit from PMA.

31 [http://www.business-standard.com/article/opinion/breaking-into-the-closed-circle-113073101234\\_1.html#.UfnKyQ\\_Cox4.email](http://www.business-standard.com/article/opinion/breaking-into-the-closed-circle-113073101234_1.html#.UfnKyQ_Cox4.email)

32 Similar policies helped India develop its auto industry.

33 <http://pmindia.nic.in/press-details.php?nodeid=1660>



## UNDERSTANDING PMA: EVIDENCE FROM OTHER COUNTRIES

Several countries adopt forced localisation policies under PMA to bolster domestic manufacturing. A recent example is the “Buy American” provisions of the American Recovery and Reinvestment Act of 2009. According to this provision, funds used for construction, alteration, maintenance or repair of public buildings and public works must procure all iron, steel and manufactured goods produced only in the US, with a price preference of 25 per cent.<sup>34</sup> The exceptions include non-availability, when the relative price against a foreign manufacturer is over 25 per cent, or where applying the provision is against “public interest” – where public interest not being defined could apply to almost any situation. The objectives of the policy are to save and create jobs, to give relief to those affected by the recession, and to invest in infrastructure, education, health and renewable energy. Many have argued against this provision, stating that it would not only damage the US’s reputation with regard to its free trade commitments but is also unlikely to have a major impact on job creation.<sup>35</sup>

The United States had first introduced the Buy America Act in 1933, which required the US government to prefer domestically made products. A similar Buy American Act of 1983 extended the 1933 legislation specifically to mass-transit-related products subsidised by federal grants or those valued at over USD100,000.

Facilitating market access for local manufacturers is thus a common instrument of state policy. Since the government is the largest consumer in almost all economies, and the only dependable source of business during economic downturns, most countries adopt measures to ensure that government spending benefits domestic industry. Procurement laws in several countries stipulate the need for government to favour local companies in procurement. For example, Brazil implemented local content requirements (LCR) in 4G telecommunication (2012-2014) and construction (2013). Canada used LCR for wind and solar energy projects (2009), Israel for textile purchases by security forces (2013), Australia for managing electronic health records (2012), South Africa for electrical components, solar water heaters, etc.<sup>36</sup> Most of these policies were

34 Steve Tibbets, 2011, “Home Field Advantage: Domestic Preferences in Government Procurement and Obligations under International Agreements.”

35 February 2009, “Buy American: Bad for Jobs, Worse for Reputation”, Policy Brief, Peterson Institute for International Economics.

36 Global Trade Alert, <http://www.globaltradealert.org/>

adopted after the global financial crisis of 2008-09 with a common objective to empower small and medium enterprises, create employment, and increase the domestic revenue base.

Protectionism, much criticized by free-traders and much favoured by anti-globalists has not disappeared as the world embraced globalisation. Its instruments have changed from explicit to implicit<sup>37</sup>. Rules defined by the General Agreement on Trade and Tariffs (GATT) permitted member countries to protect domestic production from foreign competition only through tariffs. The gradual reduction in tariffs led countries to innovate measures, popularly referred to as non-tariff barriers, to restrict imports. Non-tariff barriers include specific limitations on trade such as import licensing, customs procedures including anti-dumping practices, standards, government participation in trade, etc. During the 1980s, several countries imposed restrictions on foreign investors to protect their domestic industry, violating GATT Article III (National Treatment on Internal Taxation and Regulation) and Article XI (General Elimination of Quantitative Restrictions). Among other conditions, foreign investors were forced to comply with local content requirements, a violation of GATT Article III.4. The Agreement on Trade-Related Investment Measures (TRIMS), concluded in 1994, and agreed upon by all members of the WTO, prohibited the use of such measures, commonly notified in the agriculture and automotive sectors.<sup>38</sup> Additionally, a number of cases in the WTO reflected the use of non-tariff barriers to protect domestic industry rather than the violation of any agreed principle. For example the United States ban on imports of shrimp and shrimp products from India, Malaysia, Pakistan and Thailand, and the restriction on imports of tuna from Mexico<sup>39</sup> are interpreted as the use of NTBs to protect the domestic industry.

The financial crisis of 2008 brought about a change in the WTO's long-standing belief in the benefits of economic liberalisation.<sup>40</sup> Economies across the world saw a quiet return to protectionist measures, including tariff and non-tariff barriers to trade.<sup>41</sup> The watchdog Global Trade Alert (GTA) reported that protectionist measures imposed in the fourth quarter of 2012 and first quarter of 2013 were the worst since the financial crisis began. Table 3 below ranks countries on the level of protectionist measures adopted since November 2008.

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37 Bhagwati Jagdish, 1988, "Protectionism."

38 <http://www.meti.go.jp/english/report/data/gCT9908e.html>

39 [http://www.wto.org/english/tratop\\_e/envir\\_e/edis08\\_e.htm](http://www.wto.org/english/tratop_e/envir_e/edis08_e.htm); [http://www.wto.org/english/tratop\\_e/envir\\_e/edis04\\_e.htm](http://www.wto.org/english/tratop_e/envir_e/edis04_e.htm)

40 Clift and Woll, 2012, Economic Patriotism: Reinventing control over open markets, *Journal of European Public Policy*, 19(3), pp. 307-323

41 Ikenson, 2009, A Protectionism Fling: Why Tariff Hikes and Other Trade Barriers Will Be Short-Lived, Cato Institute.

Table 3: Countries Ranked on the Basis of Protectionist Measures Adopted

Rank	Ranked by number of discriminatory measures imposed	Ranked by the number of tariff lines (product categories affected by discriminatory measures, max 1204)	Ranked by the number of sectors affected by discriminatory measures (max 79)	Ranked by the number of trading partners affected by discriminatory measures (max 232)
1	EU 27 (372)	Vietnam (943)	EU 27 (78)	EU 27 (201)
2	Russian Federation (231)	Venezuela (787)	Italy (78)	Italy (194)
3	Argentina (185)	Kazakhstan (738)	Argentina (73)	China (193)
4	India (113)	China (705)	Germany (66)	Indonesia (170)
5	Belarus (101)	EU 27 ( 676)	Algeria (58)	India (164)
6	Germany (99)	Nigeria (603)	Russian Federation (54)	Netherlands (164)
7	United Kingdom (98)	Indonesia (558)	China (52)	United Kingdom (164)
8	Italy (94)	India (514)	Kazakhstan (50)	Germany (160)
9	France (91)	Argentina (499)	USA (47)	France (159)
10	Brazil (80)	Algeria (485)	Nigeria (45)	Poland (159)

Source: GTA Database

The plurilateral agreement on government procurement (GPA) is part of the WTO’s constant efforts to promote open and free trade. Re-negotiated in 2012, the GPA has created an effective legal framework for greater liberalisation of government procurement. Plurilateral agreements are signed by countries with similar objectives; countries decide to establish among themselves a common set of guidelines, often dealing with a particular sector. Plurilateral deals create rights and obligations among a narrower group of WTO members and therefore, are different from multilateral agreements. Examples include the Agreement on Trade in Civil Aircraft, Agreement on Government Procurement, Financial Services Agreement, Anti-Counterfeiting Trade Agreement (ACTA), Informational Technology Agreement (ITA), etc. The GPA has put in place a non-discriminatory clause that prevents signatories from protecting domestic services and suppliers. Article III (National Treatment and Non-discrimination) of the GPA explicitly states that all signatories to the GPA **should not treat a locally-established supplier less favourably than another locally-established supplier on the basis of degree of foreign affiliation or ownership**. Currently, 42 countries (including 28 EU member countries) are party to the GPA, while 27 are observers. Ten of the 27 observer countries are negotiating accession. India is an observer.

Essentially, this implies that preferential market access policies implemented in the form of local content requirements cannot be implemented by any WTO member for commercial/private sector businesses, but can be used for government procurement in case they are not party to the GPA. India, an observer to the GPA and mindful of its international trade obligations, has limited its PMA only to government procurement, which is permissible and WTO-compliant, although with a benign preference for domestic manufacturers. While the policy does not alter the competitiveness of foreign products in India, foreign firms with well established global supply chains might need to bear the cost of re-orienting their manufacturing and sales processes in order to meet requirements of the proposed law.

## EFFICACY OF INDIA'S PMA POLICY

Criticism from foreign investors aside, a more important and relevant issue for Indian policy makers is to evaluate whether the PMA is indeed optimal from the point of view of achieving its stated objectives. There is no clear consensus on whether such a policy will help India achieve either of its objectives, i.e., manufacturing or/and security, in the current scenario. India's concerns, however, are valid: rising demand for electronics does create a need for India to urgently develop long-neglected electronics manufacturing capabilities. Additionally, the deployment of high technology equipment has become a major security concern for India. In July 2013, Huawei, a Chinese telecom vendor, is reported to have attacked the public sector service provider BSNL's Base Switch Controller (BSC) in Andhra Pradesh from a remote location in Chennai through the internet.<sup>42</sup> The BSC's software completely crashed as a consequence of this attack. Although the attack was said to be the result of rivalry between two private telecom vendors, it reflected a larger security threat, the costs of which can be enormous. India needs to secure itself against similar attacks on main switching centres and intelligent network platforms, which could have a much larger impact than the incident cited above.<sup>43</sup> In 2012, the government dealt with a serious security challenge arising from the use of Blackberry phones. After a lengthy battle with the device manufacturer, the government finally won access to its data.<sup>44</sup>

Both objectives, therefore, are important to pursue and require immediate government attention. Whether the PMA can address these twin objectives, is a question that remains to be answered. There have been suggestions to delink the 'security' and 'manufacturing' aspects of the policy.

The claim that PMA will help resolve security concerns is contentious. According to the PMO, security objectives could be met through audits, tests, and should be handled separately from achieving higher domestic manufacturing. However, the Department of Telecommunications (DoT) continues to lay stress on the

42 "Center to probe alleged hacking of BSNL network by Huawei", The Hindu, December 30, 2013 <http://www.thehindu.com/news/national/centre-to-probe-alleged-hacking-of-bsnl-network-by-huawei/article5516261.ece>

43 "Center to probe alleged hacking of BSNL network by Huawei", The Hindu, December 30, 2013 <http://www.thehindu.com/news/national/centre-to-probe-alleged-hacking-of-bsnl-network-by-huawei/article5516261.ece>

44 Government, Blackberry end dispute over interception of BB Devices, Economic Times, July 10, 2013. [http://articles.economictimes.indiatimes.com/2013-07-10/news/40492683\\_1\\_blackberry-services-blackberry-messenger-interception-solution](http://articles.economictimes.indiatimes.com/2013-07-10/news/40492683_1_blackberry-services-blackberry-messenger-interception-solution)

need for localised manufacturing to nip this problem in the bud, therefore linking the two objectives. It must be reiterated that domestic manufacturing does not imply indigenous manufacturing, as under PMA there is no distinction between an Indian and a foreign company in India. Therefore, domestic manufacturing is not going to ensure complete security. According to the Telecom Systems Design and Manufacturers Association (TDMA), telecom equipment consists of very complicated and advanced elements with software codes in which spyware and malware can be implanted in a way that may not be captured by the country's testing capabilities.<sup>45</sup> However, the United States has successfully used its testing procedures to help the country identify security loopholes in products supplied by Chinese telecom manufacturers.<sup>46</sup>

The government acknowledges the immediate need to address security considerations. Accordingly, new testing standards are due to be announced by the Department of Electronics and Information Technology, Department of Telecommunication (DoT) and the National Technical Research Organisation (NTRO).<sup>47</sup> The Common Criteria Recognition Arrangement (CCRA)<sup>48</sup> clearance is no longer enough to certify global telecom gear used in India.<sup>49</sup> DoT has also established a pilot lab and the creation of a full-fledged certification centre is in progress. The National Cyber Security Law<sup>50</sup> introduced in 2013 proposes strategies to create a secure computing environment in India with adequate trust and confidence in electronic transactions, software, services, devices, and networks. These measures, if implemented well, can help address India's security challenges.

PMA can enable the process of ensuring more security, but does not guarantee it in the absence of other measures. There is a massive demand-supply gap for telecom equipments in India. According to TRAI's Recommendations on Telecom Equipment Manufacturing Policy, 2011, India will constitute about 8% of the global demand in 2019-20, yet meet less than 40% through domestic manufacturing. The current market is largely dependent on imports of both components and final products. A lot more than the PMA will be required for domestic manufacturing to catch up and match security standards in the long term. Other initiatives, such as those mentioned above, are likely to be more potent in addressing security concerns in the short-term. A more focused approach on testing equipment may be preferable to complete reliance on "Made in India" products.

PMA can however be one of many instruments to promote domestic manufacturing. Promoting manufacturing will require the government to facilitate research and development, fund equity, provide good logistics, and create effective infrastructure. An improved business environment will encourage domestic manufacturers and make Indian industry more attractive for foreign investments. The National Manufacturing

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45 <http://www.lightreading.in/lightreadingindia/news-analysis/172114/domestic-vendors-quick-pma-roll>

46 Rajiv Kher, Additional Secretary, Ministry of Commerce, [http://www.communicationstoday.co.in/index.php?option=com\\_content&task=view&id=7889&Itemid=147](http://www.communicationstoday.co.in/index.php?option=com_content&task=view&id=7889&Itemid=147)

47 NTRO is the country's technical intelligence gathering agency under the Prime Minister's Office.

48 CCRA ensures that products can be evaluated by competent and independent licensed laboratories to determine the fulfilment of particular security properties. Supporting documents are used within a common criteria certification process to define how the criteria and evaluation methods are applied when certifying specific technologies. The certification of the security properties of an evaluated product can be issued by a number of Certificate Authorising Schemes, with this certification being based on the result of their evaluation. These certificates are recognised by all signatories to the CCRA and motivate global telecom vendors to find common processes and reduce equipment certification costs worldwide.

49 [http://articles.economictimes.indiatimes.com/2013-06-20/news/40093764\\_1\\_telecom-gear-telecom-equipment-security-sensitive-telecom-products](http://articles.economictimes.indiatimes.com/2013-06-20/news/40093764_1_telecom-gear-telecom-equipment-security-sensitive-telecom-products)

50 [http://deity.gov.in/sites/upload\\_files/dit/files/National\\_cyber\\_security\\_policy-2013.pdf](http://deity.gov.in/sites/upload_files/dit/files/National_cyber_security_policy-2013.pdf)

Policy (2011)<sup>51</sup> also recognised the need for India to bolster domestic manufacturing. It outlines challenges faced by manufacturing including inadequate physical infrastructure, a complex regulatory environment, and inadequate availability of skilled manpower. Several proposals have been made to help India achieve increases in manufacturing activity, one of which is the setting up of National Investment and Manufacturing Zones (NIMZ). The National Telecom Policy 2012 and National Policy on Electronics 2011 also propose several measures to drive manufacturing in telecom, IT and electronics. In particular, the Modified Special Incentive Package Scheme (M-SIPS)<sup>52</sup> proposes to attract investments in the Electronic Systems Design and Manufacturing (ESDM) industry using subsidies for investment in capital expenditure.

In the broader context, PMA alone seems to be a feeble attempt at driving domestic manufacturing, given that manufacturers need more than just access to government procurement to become as competitive as a foreign supplier. According to an estimate provided by Booz & Co,<sup>53</sup> infrastructure disabilities lead to a cost disadvantage of 6 to 8 per cent for Indian manufacturers. Progress in infrastructure development, labour reforms, smooth credit, an improved intellectual property rights regime, and reduced red-tapism, when addressed, can ensure greater success of the PMA policy.

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51 [http://commerce.nic.in/whatsnew/National\\_Manufacturing\\_Policy2011.pdf](http://commerce.nic.in/whatsnew/National_Manufacturing_Policy2011.pdf)

52 <http://pib.nic.in/newsite/PrintRelease.aspx?relid=85303>

53 Booz & Co and COAI, 2012, “Telecom Equipment Manufacturing Policy – Developing an Actionable Roadmap.”

## CONCLUSIONS

**F**orced Localisation under the ambit of Preferential Market Access policies is often referred to as “the new protectionism”. Countries adopt a variety of measures that are designed to protect, favour or promote domestic industries. For example, China’s policy is related to compulsory intellectual property transfer, while those of India, Argentina, Brazil, China, Indonesia, Malaysia, Nigeria, Russia, Turkey, and Vietnam, among many others, have introduced local content requirements for sectors ranging from information and communications technology (ICT), to energy, pharmaceuticals, financial services and the media. India, entrenched in manufacturing policy failures, has adopted the PMA to fix its glaring weakness in electronics and telecom manufacturing. Among several other initiatives promoted by the government, this is yet another well-intentioned policy.

Domestic manufacturers, especially telecom equipment makers supporting PMA, believe that the policy will encourage entrepreneurs to start product manufacturing in India.<sup>54</sup> While PMA addresses the demand side challenges of the industry, proposals in India’s recently introduced National Manufacturing Policy, National Telecom Policy, and National Electronics Policy tackle the supply side bottlenecks including capital expenditure, research and development, physical infrastructure, etc. PMA in this context is part of a policy mix and cannot yield successful results as a standalone initiative.

PMA does not represent a reversal of India’s economic reforms, it is more promotional than protectionist in nature. As argued above, it is in line with the local content requirement policies adopted by different countries to address domestic priorities. However, reactions from US business bodies have raised several concerns, some of which appear unwarranted. While there is no publicly available estimate on the loss accruing to American businesses due to the PMA, the impact would be quite limited due to the restricted application to government procurement at similar levels of price and quality.

Under the PMA, domestic manufacturers are not likely to create massive market distortions. The concern of investors that PMA represents a return to protectionism, therefore, may not be borne out. Apprehensions about the extension of the policy to the private sector have been belied and concerns about its extreme protectionist nature also seem exaggerated.

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54 Feedback from the Telecom Equipment Manufacturers Association, India.

On the other hand, if successfully implemented, the PMA may add to the manufacturing capacity of domestic firms, the benefits of which will spill over to foreign investors in terms of technology demand, a stronger intellectual property regime and improved infrastructure.

Given India's current environment of weak infrastructure and poor policy implementation, the stated objective of increased domestic manufacturing by mandating local content may not be realised. The public sector is unlikely to effectively lead a manufacturing surge without a renewed domestic reform push that creates an enabling environment for the private sector to operate more freely. In this context, the newly introduced policies on manufacturing, especially in telecom and electronics, are a ray of hope.

The PMA may or may not deliver on its stated objectives, but in its current form, it does not violate India's international obligations. Most importantly, the revised PMA policy has ruled out private sector coverage addressing the apprehension of foreign companies. It provides clarity to domestic manufacturers with regard to policy incentives and asserts the focus on price and quality competitiveness. Security issues, which have provided the initial impulse to PMA, are also being dealt with separately; the National Security Council has been handed the task of defining security-related issues concerning products, projects or sectors. Additionally, alternative approaches to handling security-related products are being proposed, which include modes of certification and a roadmap for building domestic testing capacity.

The revised updated PMA policy will perhaps meet its basic objectives, while taking into account the interests of all stakeholders, domestic and foreign. To be successful during its existence over ten years, we need a well planned roadmap and simultaneous complementary efforts that overcome the weaknesses in the domestic market.



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# Policy Report #2

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## India's Investment Climate: Addressing Concerns about Tax Policy

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## Policy Report #2

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# India's Investment Climate: Addressing Concerns about Tax Policy

Rajiva Ranjan Singh<sup>1</sup> and Neetika Kaushal Nagpal<sup>2</sup>

**Abstract:** Amidst a deteriorating economic environment due to multiple factors, certain direct tax related developments during 2012 led to an outcry among the international investor community. US multinational enterprises (MNEs), by virtue of their large presence, joined this chorus, fearing major adverse consequences for the cost of doing business in India. While issues of permanent establishment and transfer pricing under international tax regimes have been a sore point for MNEs for some time, the introduction of the General Anti-Avoidance Rules (GAAR) and retrospective amendments of tax law in 2012 were seen as unprecedented and adversarial for business and industry. Although India's tax policy and law is generally in line with that in other tax jurisdictions, its implementation is not in tune with the international best practices followed by successful tax administrations globally. The Indian government has since taken certain steps to soothe investor sentiment but a lot more needs to be done for India to become an attractive destination for investors in a highly competitive international environment.

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**“Every government has a right to levy taxes. But no government has the right, in the process of extracting tax, to cause misery and harassment to the taxpayer and the gnawing feeling that he is made a victim of palpable injustice.”<sup>3</sup>**

**— Nani A. Palkhivala**

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3 Excerpt from “Nani Palkhivala - A Role Model” edited by Maj Gen Nilendra Kumar, third edition, published by Universal Law Publishing Company (2009).

## INTRODUCTION

After the economic reforms of 1991 and subsequent removal of regulatory and trade barriers, India emerged as a major force in the global market, becoming a hub of business process outsourcing, an attractive investment destination for foreign direct investment (FDI) and a dominant exporter of services. In a span of two decades, almost all leading multinationals have established operations in India, engaging Indian skilled labour in their business.

However, this opening of the domestic economy and its greater integration with the global economy has posed new challenges to the existing tax system. Besides fulfilling the traditional objective of collecting taxes to raise revenue in an equitable and efficient manner, policymakers and administrators are now confronted with the challenge of harmonising the domestic tax system with international practices, standards and norms<sup>4</sup>. This has become imperative not only to minimise tax gaps and overlap of taxation but also to encourage greater investment in the economy.

While India has made considerable progress in lowering its tax rates, making the tax structure more robust and broadening its tax base, some issues remain to be addressed. These have assumed greater importance with the introduction of complicated corporate structures, transactions and businesses. Broadly, they range from whether a foreign enterprise is conducting business in India through a permanent establishment, how it attributes its profits to the establishment, what is the nature of income being generated through business, whether it is royalty or fee for technical services and how the goods and services bought from or sold to the entity are valued under transfer pricing rules.

These issues that affect almost all multinational enterprises (MNEs), including US resident enterprises, have given rise to a number of tax related disputes. These disputes take many years to resolve and multiply the compliance cost, arising from litigation costs, of businesses. Moreover, the backlog of unresolved disputes results in uncertainty regarding taxation of international businesses. This renders doing business in India risky and adversely impacts its competitive position in the international market.

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4 Ernst & Young (2008) "International Taxation in India, Issues and Concerns - Background Research Paper."

While the Finance Minister of India has repeatedly promised a stable and non-adversarial tax regime on public platforms, frequent legal changes as well as varied and inconsistent interpretation of laws by the Income Tax Department (ITD) have proved to be a deterrent for companies looking to invest in India. From retrospective changes in tax laws to an aggressive stand on transfer pricing (TP) and the hasty introduction of the General Anti-Avoidance Rules (GAAR), the Indian government and tax administration has been on an overdrive to increase revenue collection to meet its annual targets. This strong pro-revenue positioning has created uncertainty and instability for a foreign investor looking to invest and capitalise on the growth potential of a market comprising more than 1.2 billion people.

It may not be as much the regulatory changes as the recent disputes involving high-profile foreign enterprises that have increased the apprehensions of the investor community and vitiated the Indian business climate. The tussle between the ITD and Vodafone Plc over the European mobile company's acquisition of Hutchison Whampoa Ltd's Indian operations in 2007 was just the tip of the iceberg. What followed was a plethora of TP disputes involving Royal Dutch Shell, HSBC Securities and Capital Markets, Standard Chartered Securities and Vodafone Plc on issuance of shares by the Indian subsidiary to the foreign parent. Both Vodafone and Shell India have taken the income tax department to court challenging the department's stance that share transactions between group companies fall under the TP net. Recently, Nokia Plc was slapped with a tax demand for failure to withhold tax on royalty payment made to the Finnish parent. Other MNEs facing tax disputes in India include Morgan Stanley, Convergys, IBM, Microsoft, etc. These actions by the ITD have stirred strong reactions from not just domestic and international businesses but also industry chambers, associations as well as governments, including those of the US and the UK, whose resident companies face huge tax demands in India.

Globalisation has created opportunities in new markets, resulted in complex production and supply chains, and led to the growth of intangibles such as patents, royalties, service fees, etc. Companies have mostly done everything that they can to capitalise on these opportunities and shift from a country-specific operation model to a global model that allows businesses to establish operations in various countries to reap cost and location advantages. The emergence of a digital economy comprising delivery of services and digital products over the internet from one country to another has provided further benefits to MNEs while raising the complexity of tax administrations.

All of these developments have increased the sophistication and boundaries of tax planning by making available legal arbitrage opportunities. MNEs are shifting income from countries where goods and services are produced to countries where there is low or no tax. While countries do provide relief from double taxation by signing Double Taxation Avoidance Agreements (DTAAs) with some trading partners, they also take measures to prevent tax base erosion and shifting of profits from their countries in an attempt to evade taxes. This base erosion and profit shifting (BEPS) has been recognised as a serious issue by G20 countries, who are now planning to take co-ordinated action based on OECD's suggested action plan report.<sup>5</sup> Australia, which holds the G20 presidency in 2014, has cited BEPS as one of the critical issues facing the G20, and aims to discuss it at length with other partner countries.

However, these issues pertaining to taxation of international businesses and their transactions are not limited to India. Developed economies face prospects of revenue shortfalls because of aggressive tax planning

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5 OECD (2013), 'Action Plan on Base Erosion and Profit Shifting', OECD Publishing.

and the adoption of avoidance practices such as routing transactions through low tax jurisdictions by large MNEs. Developing economies are torn between the need to design robust tax systems attractive to international investors while simultaneously meeting their own revenue goals.

Most developed countries keep a check on the number of tax disputes arising and limit them by providing clear guidelines on the provisions and interpretation of laws. This is coupled with the empowerment of tax administrators to resolve tax disputes expeditiously, which curbs expenditure on litigation. Developing countries have taken their cue from the practices followed by developed countries to make their dispute resolution mechanisms efficient and effective. Leading emerging economies such as Indonesia, Malaysia, South Africa and Brazil have succeeded in meeting their objectives and overcoming challenges, keeping in mind the need for a certain and stable tax environment.

But the Indian tax administration, in spite of making concrete changes to its dispute resolution mechanism to align it with global practices, has failed to deliver key results. It is often pointed out that the tax administration follows an arbitrary approach. There is inconsistency in the interpretation and enforcement of laws and provisions, creating difficulties in the business decision-making process. The administration is not receptive to the needs of taxpayers and repeatedly formulates policies without any consultation/interaction with industry. This creates a dilemma for businesses and results in disconnect between government policy and its implementation by the tax administration. Moreover, the tax authority gives the impression of being distrustful of taxpayers, time and again resorting to harassment. The latest World Bank study on Doing Business (2014) ranks India at a dismal low of 158 in 'ease of paying taxes' out of 189 economies. India stands well below other BRIC countries – China (91), Russia (112), and Brazil (130) – and many OECD countries like South Korea (8), Sweden (13) and Mexico (48).

In its 2008 report<sup>6</sup>, Ernst & Young notes that India's current international tax treaty regime mirrors positions that were considered appropriate when it was an importer of capital, with limited cross-border trade. But this is no longer true. India is emerging as both an importer and exporter of capital. This has rendered the current models of tax treaties obsolete.

There is little doubt that India needs to reform tax application and administration procedures pertaining to international transactions and businesses to ensure fairness, transparency and consistency. Most of this is attainable by modernising tax administration through automation and standardisation, quick resolution of disputes, and providing high quality taxpayer information services. An information technology-driven tax administration will not only reduce the complexity of doing business but also reduce the compliance cost of taxpayers as well as the administrative cost of the government.

The United States-India Business Council (USIBC), in the US as well as in India, has pointed out repeatedly the tax related concerns of US multinationals. Most US-resident companies with operations in India face scrutiny and audit by tax authorities. US companies have raised their voice against the Indian tax authorities and policymakers and pointed out that the continuance of these concerns would seriously impede investment. Against this backdrop, this study discusses on five key issues relating to the Indian tax regime that MNEs find causes for concern.

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6 Ernst & Young (2008) "International Taxation in India, Issues and Concerns - Background Research Paper."

The paper is arranged in the following manner: Section 2 provides a background of the deteriorating tax environment in India and its causes; Section 3 discusses tax avoidance and tax evasion; Section 4 examines issues concerning GAAR; Section 5 examines international taxation matters including those relating to Permanent Establishments (PE), Transfer Pricing (TP), and dispute resolution; Section 6 elaborates on retrospective amendments; Section 7 discusses OECD's Action Plan on Base Erosion and Profit Shifting (BEPS); and Section 8 concludes and outlines recommendations on what needs to be done to improve the tax administration.

## BACKGROUND – HOW IT ALL STARTED

Amidst a deteriorating economic environment on account of the global financial downturn and domestic policy constraints, some recent actions and attempts by the government to raise revenue by altering taxation laws have left investors in deep distress. MNEs which have invested billions of US dollars in establishing their service or production units in India are panicking about the growing uncertainty in tax law and the whimsical behaviour of tax policy makers. They are raising concerns through industry lobby groups about the impact of these recent changes on their operating costs, compliance costs and profit margins.

While apprehensions among large MNEs operating business units in India had almost reached their peak over the last decade with tax administrators raising unreasonable tax demands on account of PE and TP, the sudden introduction of the GAAR with retrospective effect through the Finance Act of 2012 proved disastrous. It was widely believed that the action was an attempt by the government to get back at Vodafone Plc, which won the case in Supreme Court over the exchequer's tax demand of Rs. 18,000 crore as withholding tax against its transaction with Hutchison India. This was followed by many such tax demands raised by the department on international transactions involving multinationals. These actions of the government suddenly made the Indian tax department a draconian organisation, which it appeared was out to make all international investors and businesses unwelcome in India.

Another adversarial step by the Indian tax department was the decision to tax research and development (R&D) centres in India that came through the issue of two circulars – Circular 2/2013 (on application of profit split method) and Circular 3/2013 (on conditions relevant to identifying development centres engaged in contract R&D services with insignificant risk) on March 26, 2013, by the Central Board of Direct Taxes (CBDT). The former imposed the profit split method to calculate tax on R&D centres while the latter listed conditions to determine arm's length price (ALP)/transfer price for services offered by contract R&D centres. After much uproar and contention, Circular 2/2013 was withdrawn while Circular 3/2013 was modified and replaced with Circular 6/2013 on June 29, 2013.

The issue of tax demand relating to non-deduction of tax at source on payment of royalty by an Indian subsidiary to its foreign parent has also come under severe criticism from industry after the recent case of Nokia India. The ITD has raised a demand of Rs. 21,000 crore on Nokia as withholding tax on royalty pay-

ment made to the parent company. The industry is questioning the delayed response of the tax authority in raising a tax demand now on transactions that occurred eight years ago. The ITD suffered a huge blow when the Delhi High Court ordered that the freeze on the sale of Nokia's Indian unit located in Chennai to Microsoft to be lifted on the condition that the entity deposits Rs. 2,250 crore in an escrow account and gives an undertaking that it will pay the tax dues if it were to eventually lose the case.

While the Indian tax administration is making efforts by introducing tools such as advance pricing agreements (APA) and safe harbour rules, there is still considerable apprehension in the minds of businesses and investors that the unforeseen modifications in tax law introduced in 2012 could continue to happen routinely and abruptly in the future as well.

## TAX AVOIDANCE AND TAX EVASION

From times immemorial, taxpayers have arranged their tax affairs in a manner to efficiently minimise their tax liabilities, termed as tax mitigation, or avoid taxes by taking advantage of loopholes in provisions, termed as tax avoidance. When done within the four corners of prevailing tax laws, such tax mitigation and tax avoidance are permissible and legal. However, none of this includes tax evasion, which often involves falsification of records or suppression of facts. Universally, tax evasion is considered illegal and is subject to severe penalties if proved.

While there is a thin dividing line between tax avoidance and tax evasion, tax administrations of both developed and developing countries have lately started to frown upon tax avoidance on the ground that measures adopted by taxpayers, though strictly legal in form, are illegal in substance. They claim that businesses often arrange their transactions and units in a legal manner but with the sole objective of evading taxes. This is considered unethical by tax administrations. In order to check such unethical arrangements, tax administrations the world over have introduced measures like anti-avoidance rules, transfer pricing, etc. in their statutes.

The subject of tax avoidance was first discussed in the OECD report on ‘Harmful Tax Competition – An Emerging Global Issue’ released in 1998. It underlined two major problems facing international taxation: (a) tax havens; and (b) preferential tax regimes. The objective was to publicise a tax policy regime that eliminates both these problems in order to preserve the tax base of source countries and to ensure equity between nations by providing a level playing field to all countries. To deal with specific instances of tax avoidance, tax authorities and policymakers globally have reacted by introducing legislative amendments to laws pertaining to anti-avoidance. A number of countries such as Australia, Canada, New Zealand and South Africa have enacted GAAR while others such as the UK and the US have adopted a vigorous judicial anti-avoidance doctrine.<sup>7</sup>

In India, the implementation of anti-avoidance measures combined with the anti-taxpayer attitude of the tax administration has created further contention for businesses as well as the tax authority. It was repeatedly pointed out during stakeholder consultations held for this project that in the case of India, the quantum

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7 S. Goradia, 2012. “GAAR Impact on Cross-Border Structuring”, BMR Insights published by BMR Advisors.



of taxes payable is not a problem; it is the excessive cost of compliance due to arbitrary and uncertain tax practices, lack of transparency and unfavourable attitude of tax administrators towards taxpayers that create obstacles in conducting business smoothly. Most MNEs feel that in India, applicable tax rates are similar to those in other countries. Hence, the need to follow aggressive tax planning is unwarranted. But the behaviour of the tax administration towards the taxpayer is instinctively driven by the assumption that the latter is evading taxes. This has an adverse effect on the approach that the administrator adopts towards the taxpayer. Most MNEs complain of yearly scrutiny and audit of their accounts, unfair tax demands of the department and harassment from tax officials.

Tax administrators in developed countries make serious attempts at examining taxpayer behaviour, and the factors that affect it and then accordingly formulate strategies. However, no such concrete effort is made by the Indian administration. There is a huge body of literature that supports the hypothesis that a better understanding of the motives of taxpayers and their attitude towards taxation can improve both voluntary compliance levels and efficiency in tax administration. During the stakeholder consultations held for this study, it was pointed out that the behaviour that business entities face in India from the tax administration is worse than in many other developing economies. This attitude, which is highly underplayed and discounted by the Indian government, is in reality a major determining factor for investments. Companies with presence across several tax jurisdictions like to go to countries where the tax environment is favourable. There is certainty that goal posts will not be shifted without a proper and adequate notice period. Moreover, the attitude of the administration and its trust in taxpayers is vital. In the case of India, a deficit of both these factors has hindered investments in recent years. As the 2008 Ernst and Young report notes, “efforts in this direction need to percolate from the topmost levels to the grass roots and the spirit of such an endeavour needs to be communicated to one and all”.

## GENERAL ANTI-AVOIDANCE RULE (GAAR)

Although GAAR has been in discussion since 2008 when the first draft of the Direct Tax Code (DTC) was introduced, it became a matter of contention in India more recently when it was introduced through amendments to the Finance Act 2012, announced in the annual budget speech of 2012 by the then Finance Minister Pranab Mukherjee. Until recently, anti-avoidance in India was resolved through judicial proceedings in courts. There was no statute codifying anti-avoidance rules. The proposed GAAR empowered the Indian tax authorities to declare a transaction as an ‘impermissible avoidance arrangement’, devised to avoid tax by using India’s tax treaties, and deny all tax benefits that may arise if one of the purposes of the transaction or arrangement was to avail of a tax benefit. This was contradictory to the provisions of GAAR in the proposed DTC (2008), under which the rules could be invoked only when the main purpose of the transaction under review was to avail of tax benefits.

This sudden announcement created panic among businesses and had a huge impact on business and industry sentiment, evoking widespread opposition from foreign institutional investors (FIIs) as well as MNEs. A further trigger to the fiasco was the enactment of certain provisions relating to retrospective taxation in conjunction with GAAR as an instrument, firmly leading to the belief that it was a result of the revenue department’s determination to counter the Supreme Courts’ decision pertaining to Vodafone Plc. The outcome was universal condemnation of not just India’s unpredictable approach to tax administration procedures but also of its policymakers, responsible for framing and enacting laws.

Consequently, the provisions of GAAR were put on hold in June 2012 and a committee to review the rules was set up under the Chairmanship of Dr. Parthasarathi Shome in July 2012. The Shome Committee, through intensive stakeholder discussions and analysis of the international experience, recommended the introduction of modifications to GAAR in its report submitted in September 2012. Finance Minister P. Chidambaram accepted most of the recommendations of the Shome Committee and deferred the implementation of GAAR to April 2015. This provided respite to MNEs, who now got an opportunity to review their investments and business arrangements and reflect on the commercial rationale of their operating structures.

GAAR is a global concept that empowers revenue authorities of a country to deny tax benefits to a taxpayer for a transaction or arrangement, which otherwise has no commercial substance other than to avail of tax

benefits. The basic critique of a statutory GAAR is that it provides tax administrators with wide discretion and authority, and could result in the imposition of an excessive tax and compliance burden on the taxpayer without commensurate remedies.<sup>8</sup>

In recent times, with the presence of businesses in different countries and a rise in cross-border transactions, sophisticated forms of tax avoidance have emerged.<sup>9</sup> This has partly been due to the existence of tax treaties spanning multiple jurisdictions, which prevent the incidence of double taxation. In the case of India, tax avoidance has become a particularly vexing issue because of its treaty with low tax jurisdictions like Mauritius, Cyprus, Singapore, etc., from where most capital flows into the country. However, a balanced approach requires that genuine transactions consummated in a tax efficient manner must be differentiated from sham transactions or dubious devices used for evading tax. To make this distinction, GAAR is considered to be a globally accepted, powerful instrument in the hands of revenue authorities and hence, has been implemented in several countries.

Despite GAAR's global acceptance and existence, what went wrong in the case of India was the abrupt and ill-conceived manner in which anti-avoidance rules were conceptualised and brought on the statutes, and some of the provisions that were made part of it. The Shome Expert Committee Report on GAAR (2012) points out that the international practice when introducing GAAR has generally involved a thorough analysis by experts, wide ranging discussions with stakeholders and caution in implementation. India has closely followed the UK's principles and judicial pronouncements on such issues for a century, taking a different view wherever appropriate. But India's GAAR provisions and the method followed for its implementation in 2012 bore barely any resemblance with the UK's GAAR process. Moreover, the issue of placing immense powers in the hands of the tax administration to review every transaction under the GAAR lens is often addressed in other countries by providing adequate safeguards. This has not yet been done in India. The government has not provided any guidelines on the implementation and interpretation of GAAR, and its usage with instruments such as TP, which have been made available to the tax administration since 2002. Another reason why stakeholders were shocked was the weak and deteriorating economic environment in which GAAR was introduced.

There were four aspects of the GAAR that irked foreign investors and were highlighted during the consultation meetings held with stakeholders for the purpose of this research – coverage, application, ambiguity and overrule. The provisions relating to GAAR appear in Chapter X-A (Sections 95 to 102) of the 2012 Finance Act. Unlike the provisions in DTC (2008), GAAR under the Finance Act (2012) had broadened the scope to cover transactions/arrangements in which only one of many dominant purposes was to avail of a tax benefit. This implied that all transactions resulting in a reduction in tax liability, even when the transaction is otherwise justifiable from a commercial standpoint and has not been carried out with the sole objective of tax benefit, would be brought under the ambit of GAAR. This was certainly more threatening for businesses as it dissolved the filter for sifting transactions where tax benefit is not the main purpose and brought a larger number of transactions/arrangements under the tax administrations' scanner. There were also serious stakeholder concerns that GAAR may frequently be invoked by the tax administration even when the tax benefit availed of did not essentially represent tax avoidance, resulting in increased litigation and persecution of the taxpayer. An independent study commissioned by Her Majesty's Revenue and Customs (HMRC) of UK has

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8 Expert Committee Report on General Anti-Avoidance Rules (2012).

9 Expert Committee Report on General Anti-Avoidance Rules (2012).

found that such a wide- spectrum GAAR is harmful as it erodes the attractiveness of the tax system to businesses. GAAR are better if applied moderately and are targeted at only those transactions/arrangements that are contrived and artificial. Many countries with anti-avoidance rules limit their application to only those transactions/arrangements that have tax benefit as the sole purpose. In fact, grandfathering of the business arrangement until the date that these provisions are introduced in the statutes to allow time to taxpayers to withdraw or modify business arrangements that are undesirable or which constitute impermissible tax avoidance measures may be a better way of handling the problem.

Second, the provisions authorised the tax administration to treat the whole arrangement of the assessee as ‘impermissible avoidance arrangement’, even if only a part of the arrangement was impermissible and the rest was permissible. Apprehensions were raised by stakeholders that the administrators would impose a penalty on the entire value of the transaction instead of only on the part that reflected tax benefit. The Shome Expert Committee (2012) addressed this by suggesting that the consequences of an ‘impermissible avoidance arrangement’ be applied only to the part of the arrangement that is impermissible.

Third, the language of GAAR provisions lacked clarity and left room for interpretation by both the tax authority and the taxpayer. The provisions did not clearly define the meaning of an impermissible avoidance arrangement, implying that any arrangement could be potentially considered impermissible without distinguishing whether it is an avoidance arrangement or not. Uncertain provisions with open-ended language can lead to harassment of taxpayers as the tax administrator is empowered to legally bring in any transaction with tax benefit, even if did not represent tax avoidance, under GAAR. This insecurity was likely to act as a major stumbling block for MNEs, which usually have operations in multiple locations and jurisdictions in various legal forms.

The fourth troublesome aspect of GAAR for foreign investors was the overriding of tax treaties by domestic law. Internationally, it is a well accepted principle of interpretation that in the case of a conflict between the provisions of domestic law and an international tax treaty, whatever is more beneficial to the taxpayer is applicable. However, with the new GAAR provisions, the benefit to the taxpayer was restricted to domestic law, which would supersede provisions in tax treaties.

In recent years, especially after the Vodafone case and the announcement on GAAR, India’s revenue department has come under immense pressure to prevent “treaty abuse” by foreign enterprises that use the DTAA agreements signed with tax haven or low tax countries such as Mauritius, Cyprus, etc. to lower their tax liability on income arising in India. Efforts are underway to amend India’s DTAA with Mauritius and Cyprus, which allow taxation of capital gains arising from alienation of shares only on the investor’s country of residence (Article 13). Both Mauritius and Cyprus do not impose capital gains tax. India is now proposing to amend these treaties to provide source-based taxation of such capital gains and limit the practice of “treaty abuse” by incorporating a ‘Limitation of Benefits’ (LoB)<sup>10</sup> clause. The inclusion of such a clause in tax avoidance treaties acts as a preventive against treaty abuse and can certainly be considered by India in all its future tax avoidance agreements. Since there is no capital gains tax on transfer of shares in either Mauritius or Cyprus, the entire profit goes untaxed on a global basis. India has a LoB clause in its treaty with Singapore that restricts the capital gains exemption only to those Singapore entities that are either listed on the

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10 Limitation of Benefits (LoB) is a clause that is included in double taxation conventions to prevent application of the benefits of the treaties to treaty shopping structures. (Source: Félix Alberto Vega Borrego, 2006 ‘Limitation on Benefits Clauses in Double Taxation Conventions’ published by Kluwer Law International).

recognised stock exchange or expend more than SGD 200,000 on operations in the immediate preceding 24 months in which the gains arise. It remains to be seen how the Indian revenue department treats taxpayers who invest using the tax treaty route. It is expected that tax authorities will grant treaty benefits only if there is adequate substance according to their acceptance standards.

On the basis of a series of consultations with stakeholders, the Expert Committee Report (2012) made recommendations on the GAAR provisions. It suggested that GAAR be deferred by three years on administrative grounds. It stated that there is need to understand that 'GAAR is an extremely advanced instrument of tax administration – one for deterrence, rather than for revenue generation – for which intensive training of tax officers who would specialise in the finer aspects of international taxation, is needed.' It advised that GAAR should not be treated as a revenue raising tool and only transactions that are artificial, abusive and contrived should fall within the ambit of GAAR. Moreover, whenever GAAR is applied, the government must ensure that the provisions are clear and nothing is left open to interpretation by either the administration or the tax payer. It also recommended the setting up of an approving panel, which should comprise five members with two from outside the government. The approving panel should be headed by a high court judge, include one member from the Indian Revenue Services not below the rank of Chief Commissioner of Income Tax, and one member who shall be an academic or scholar having special knowledge in matters of direct taxes and international trade practices. Further, it recommended that the directions of the panel should be binding on income tax authorities. GAAR should also not be invoked if tax benefit is less than Rs.3 crore and should not override tax treaties that have a LoB clause.

The Ministry of Finance, after careful consideration, issued a Press Note on January 14, 2013, where it accepted the major recommendations of the Expert Committee with some modifications. It deferred the implementation of GAAR provisions for two years to April 1, 2015. It agreed that arrangements where the main, and not one of the purposes, is to obtain tax benefit be considered as an impermissible avoidance arrangement. The assessing officer will be required to issue a show cause notice with reasons before invoking GAAR. At the same time, the assessee will also have an opportunity to justify the arrangement. The responsibility for proof was also shifted from taxpayer to the tax authority. The government set the limit for invoking GAAR at Rs. 3 crore worth of tax benefit and stated that GAAR will be restricted to the tax consequence of only the part of the arrangement that is impermissible.

Although the modifications were not as liberal as the recommendations of the Shome Expert Committee, which suggested grandfathering of all investments (and not arrangements) till the actual implementation of GAAR, the government indicated that only investment structures prevailing prior to August 30, 2010, would be grandfathered. While this provided relief to investors who made investments before August 2010 using the then prevailing regulations, it was unpleasant to those who invested in the period September 2010 to January 2013, when information on GAAR was ambiguous. The panel had recommended that where Specific Anti-Avoidance Rules (SAAR) provisions were applicable to a particular aspect or element, GAAR should not be invoked. The government decided that where both GAAR and SAAR provisions co-exist, only one of the two will be applied.

The government has, however, remained silent on the applicability of GAAR provisions to entities that claim tax treaty relief. It has only mentioned that GAAR provisions will not apply to those FIIs that do not claim

treaty protection. There is also no mention of the status of Circular 789 dated April 13, 2000<sup>11</sup> with reference to the Mauritius Treaty. The Shome panel had suggested that GAAR should not be invoked on Mauritius entities which have a Tax Residency Certificate (TRC).

During stakeholder consultations, it was repeatedly pointed out that before complex measures such as GAAR and TP that endow vast discretionary powers in the hands of tax administrators are implemented, it is essential that officers are intensively trained for a prolonged period. The government must ensure that it draws clear safeguards and guidelines to distinguish tax avoidance arrangements from tax mitigation arrangements to add clarity and ensure that measures like GAAR do not result in any sort of harassment of the taxpayer. The preparedness of tax officers needs to be correctly assessed to implement additional emerging and complex aspects of international and domestic taxation in a manner commensurate with international practice. It is imperative that GAAR does not lead to disputes between tax administrators and taxpayers and result in increased litigation.

Regarding tax treaties, India, as a responsible treaty partner, should re-negotiate treaties to include in-built substance requirements like an activity provision, stock exchange listing provision, or a bona fide business purpose provision so that treaty abuse is minimised or prevented. India has a LoB under its treaty with Singapore and the USA that checks tax evasion by denying benefits of the treaty to residents who do not meet additional tests.

But as much as its need and the provisions under it are debated, the implementation of GAAR is absolutely inevitable and industry must acclimatize with its future presence. However, the tax administration can make this transition smooth and taxpayer-friendly by doing away with the subjectivity and uncertainty surrounding it. In the present scenario, one of the major impediments faced by existing and prospective companies aiming to enter the Indian market is the uncertainty in the Indian tax administration regime and the capricious attitude of its tax administrators. This can be addressed by clearly drafting guidelines and safeguards when implementing GAAR. Real examples and not hypothetical scenarios can greatly help mitigate ambiguity. Another possibility can be a positive and negative list of transactions.

Although some crucial recommendations of the Expert Committee were left unaddressed, those that were accepted, especially the postponement of the implementation of GAAR, had a soothing effect on investors. All over the world, GAAR provisions are anti-tax-avoidance measures and hence, apparently draconian. However, much is dependent on the implementation of GAAR provisions and its interpretation by tax administrators. At the same time, there is also need to strengthen monitoring mechanisms. It is an open secret that most senior officers do not want to overrule adverse recommendations of adjustments/additions due to fear of departmental action against them. The government needs to put in place some mechanism to provide security and at the same time ensure that unscrupulous elements do not sabotage the purpose of tax regulations and laws.

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11 The circular provides clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius Double Taxation Avoidance Convention (DTAC). Details available at [http://www.incometaxindiapr.gov.in/incometaxindiapr/contents/CBDTFiles/Circulars/CBDTLaws/HTMLFiles/dtcdiv2\\_p0683.htm](http://www.incometaxindiapr.gov.in/incometaxindiapr/contents/CBDTFiles/Circulars/CBDTLaws/HTMLFiles/dtcdiv2_p0683.htm)

## Box 1.1: International Experience in the Application of GAAR

- (a) **Australia:** Australia was the first country to impose GAAR in 1982. The rules aimed to target contrived and artificial transactions entered into with the sole or dominant purpose of obtaining a tax benefit. Three elements govern its applicability – (i) the presence of a scheme (ii) presence of a tax benefit and (iii) dominant purpose of the taxpayer or one of its advisors entering into the scheme. In deciding on the question of purpose, eight specified matters are to be looked into to reach an objective conclusion. The onus and burden of proof lies with the taxpayer. The scope of the provisions is wide and prone to frequent disputes. GAAR is reviewed by an independent panel comprising senior tax officers and tax professionals. A framework for advance ruling regarding the application of GAAR is available.
- (b) **Canada:** In place since 1988, GAAR applies if two broad elements are satisfied. First, an avoidance transaction is defined as any transaction that results in a tax benefit unless undertaken for bona fide purposes other than to obtain tax benefit. Second, the transaction resulted directly or indirectly from an abuse or misuse of tax laws, including regulations and treaties. The Canadian Supreme Court has clarified that GAAR was enacted as a provision of last resort in order to address abusive transactions and is not intended to introduce uncertainty in tax planning. Determining abuse is a two-stage analytical process where the first stage involves identifying the relevant policy of the provision or the Act as a whole and the second is the assessment of facts to determine whether the avoidance transaction constituted a misuse or abuse with respect to the identified policy. GAAR is applied selectively. It provides for a split burden between the taxpayer and revenue authority. Potential GAAR assessments are referred to a non-statutory GAAR committee comprising representatives from the departments of finance and justice.
- (c) **South Africa:** Introduced in 2006, it enables tax authorities to apply GAAR provisions to any step or part of an arrangement, which constitutes an avoidance arrangement. For application of GAAR, four requirements need to be fulfilled, which include the existence of tax benefit as the sole or main purpose of the avoidance arrangement. Given its broad coverage, the danger of penalising fair transactions exists.
- (d) **United Kingdom:** The General Anti-Abuse Rules (GAAR) came into force from July 17, 2013, as a part of government’s approach to manage the risk of tax avoidance and strengthen HMRC’s anti-avoidance strategy. It is applicable to seven types of taxes in the UK. An independent advisory panel has been set up to give opinions on specific cases and approve the HMRC’s ‘GAAR Guidance’, published to provide broad summary of purpose, and aid its interpretation and application. This provision for anti-avoidance has come into force in the UK following a study by Mr. Graham Aaronson that conducted extensive consultations with stakeholders and suggested eschewing a broad spectrum of GAAR as it would hurt responsible tax planning.
- (e) **United States of America:** There are no GAAR provisions in US statutes. Laws have applied five main common law doctrines to deny taxpayers desired tax benefits, which include step transactions, sham transactions, economic substance, substance over form, and business purpose. In 2010, the “economic substance doctrine” was codified in US law but for any transaction to be treated under this doctrine, a two-pronged test was applied.

## INTERNATIONAL TAXATION

With an increase in cross border transactions and associated complexities, new challenges in the area of international taxation have emerged in India. These challenges include definition of permanent establishment (PE),<sup>12</sup> attribution of profits, and transfer pricing (TP).<sup>13</sup> All these issues have drawn particular attention in the last five years with the rise of tax disputes between foreign taxpayers and the Indian tax authorities.

Before going into these issues in detail, it is necessary to understand the rationale for DTAA signed by India with various countries and its relation to recent international taxation matters. With globalisation, businesses operate and trade in different countries of the world. Every country has the right to tax activities of foreign companies performed within its territories. This may result in double taxation of companies in countries where they are resident as well as in the source country where they carry out the business and earn income. To mitigate the rigours of double taxation, some countries unilaterally provide relief to its residents and most others enter into DTAAs on a bilateral basis with other countries that limit taxation of income in either resident or source country. The efficacy of the latter approach, however, depends on whether the two participating countries use common and workable interpretations of all terms and conditions.

DTAAs are either based on the OECD or the United Nations (UN) model. The OECD model gives preference to residence-based taxation. This is followed mostly by developed countries as they are providers of capital and technology. On the other hand, the UN model gives preference to source country-based taxation. This is generally followed by developing countries, who are recipients of capital and technology, to avoid erosion of tax base and profit-shifting.

India has signed DTAAs with 85 countries. Most of the DTAAs signed by India are based on the UN model

12 Permanent Establishment (PE) means a fixed place of business through which the business of an enterprise is wholly or partly carried out. It includes especially a place of management, branch, office, factory, workshop, and mine, oil or gas well or any other place of extraction of natural resources. (“Articles of the Model Convention with respect to Taxes on Income and on Capital”, OECD).

13 Transfer Pricing (TP) is the general term for the pricing of cross-border, intra-firm transactions between related parties. “Transfer pricing” therefore refers to the setting of prices at which transactions occur involving the transfer of property or services between associated enterprises, forming part of an MNE group. (United Nations Practical Manual on Transfer Pricing for Developing Countries).



where it taxes capital gains, interest, dividend and royalties, which are subject to tax deduction at source. There are some exceptions in the case of DTAAAs signed with least developed countries. In these agreements, India provides relief to companies, resident of these countries, in the form of exemption from tax deduction at source on technical services fees. With India now emerging as an investor of capital and technology in other countries, there may be a shift from source-based taxation to residence-based taxation in its future DTAAAs.

Addressing the concerns of American companies with business and operational presence in India, USIBC has taken up tax related issues affecting US companies at the highest political and government levels in the US and India. The rapidly evolving policy views of Indian revenue authorities on TP, PE and other international taxation related subjects as well as their assertion in recent cases have become a matter of great concern to American businesses. It has been contended that these developments are impeding the proper operation of dispute resolution procedures established by the existing India-US bilateral tax treaty. There is frequent disagreement between competent authorities in the US and India, which makes it even harder for companies to resolve disputes. While India's new Advanced Pricing Agreement (APA) programme helpfully acknowledges the need for improvement, American enterprises are not optimistic that APA alone can restore the bilateral tax relationship to working order if substantive points of disagreement and procedural issues are not addressed on a priority basis. USIBC opines that for India to continue to be an attractive investment destination, it must have a fair, consistent, and transparent tax environment consistent with international norms. It has also urged the Government of India to resolve the current gridlock in TP disputes in accordance with international norms.

The three major issues that have proven contentious are discussed in greater detail below.

## 5.1 Permanent Establishment (PE):

The concept of PE is of particular importance under tax treaties due to the innate nature of MNEs, which operate through multiple offices in various tax jurisdictions. It is used as a tool to define and determine the right of a source country to tax profits of an enterprise, which is a resident of another country. PE may be defined as the place of business from which the activities of an organisation are wholly or partially carried out. In the case of business income, the exercise of this right is subject to the requirement of the enterprise having a "fixed place of business". The determination of fixed place of business is fundamental to the concept of PE. To be categorised as a PE, this fixed place of business must be the place of business of the foreign entity and not of the local entity. Thus, the maintenance of a fixed place of business only for preparatory and auxiliary purposes is excluded from the definition of PE.

There are two issues concerning PE – first, the definition and scope of PE; second, the attribution of income to PE. These are discussed below.

**(i) Definition and Scope:** There is no official guideline in India on the meaning of the term PE or "place of business". This has led to a number of disputes between MNEs and the tax authority. The Indian law relies on the term "Business Connection (BC)", which does not require a fixed place of business but merely alludes to a real and continuous contact leading to a business activity that result in profit. Such a real or continuous contact for profit could be inferred from the interface between a business activity outside India and some

activity or operation within India. In the absence of a business connection, the PE would just be a taxable entity and not a tax-paying entity in India. Most Indian tax treaties list out exclusion of activities such as use of facilities for storage or display of enterprise stock, maintenance of enterprise stock for storage or display, maintenance of enterprise stock for processing by others, fixed place of business for purchases for enterprise, etc. Treaties with Germany, Sri Lanka, Republic of Korea etc., are OECD patterned and also exclude the “delivery” function. Treaties with the USA, Canada, Singapore, etc. exclude even “occasional delivery”. Some treaties expressly clarify that a combination is not a PE if the combination results in auxiliary activity.

The wide variety of ways through which a PE can be constituted and exist have been outlined in various international commentaries. But there is divergence in interpretation of the concept of PE, implying that there is no certainty on the conditions or circumstances under which a PE of a foreign enterprise can be constituted in India.

As compared to the definition of PE under the OECD or UN models, India has adopted a much wider definition in most of its DTAAs, including that with the USA. Apart from including a place of management, branch, office, factory, workshop, mine, oil or gas well, or any other source of natural extraction, it also includes farms, plantations, warehouses, stores, installations or structures used for the exploration or exploitation of natural resources, a building site or construction, installation or assembly project or supervisory activities, and furnishing of services through employees or other personnel. This broader definition has created friction between some foreign enterprises and the tax authority (refer to case of Directorate of Income Tax (DIT) (International Taxation) Mumbai vs. Morgan Stanley & Co. reported at [2007]162TAXMAN165(SC) and (2007)7SCC1<sup>14</sup>).

Another important criterion to determine whether a setup is a PE is to check if the ‘fixed place of business’ is at the disposal of the enterprise. The OECD commentary makes it clear that the premises need not be owned or even rented by the enterprise for it to be a PE. This has given rise to disputes where premises are made available to foreign enterprises for the purpose of carrying out work on behalf of the owner of the premises. In that situation, the space provided is not at the disposal of the enterprise since it has no right to occupy the premises but is merely given access for the purpose of the project. In case of Brown and Roots Inc. (an American enterprise) vs. Commissioner of Income Tax (1999 237 ITR 156 AAR), the Authority of Advance Rulings (AAR) decided that a mooring/support vessel used for installation of pipelines in the source state may be a “place of management” when the vessels were used for radio/communication, sending telex and fax, etc. and thus were used for supervision of work.

There is also a situation where a PE could be constituted based on the so-called PE fiction that refers to a situation where the foreign enterprise could be held as constituting a PE without having a fixed place of business available to it (Ernst and Young, 2008). This may include PE due to undertaking of construction activities, activities of dependent agents or presence of employees beyond a threshold number of days.

**Agency PE:** In most tax treaties, a dependent agent is defined to have a PE in the source country if it acts

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14 The Supreme Court in the case of DIT (International Taxation) Mumbai vs. Morgan Stanley & Co. concluded that the US company did not have a PE in India on most accounts except in cases where service was performed by personals on deputation, where the deputees are likely to constitute a ‘service PE’ in India. Under the India-US tax treaty, if a US company renders services through deputation of its personals in India for a specified period, then the US company will have a service PE in India.

on behalf of the foreign principal to “conclude contracts”. On the other hand, the foreign principal is said to conduct business through an independent agent if the latter is independent both legally and economically of the principal and bears all entrepreneurial risk. It provides information to the enterprise but not for business approval and the enterprise relies on special skills/knowledge of the agent.

However, in the case of most treaties, India does not follow the interpretation given in the OECD commentary. A PE is said to be constituted if the dependent agent secures orders or maintains an inventory of goods for delivery on behalf of the enterprise. India is of the view that the mere fact that a person has attended or participated in negotiations in a state between the enterprise and a client can, in certain circumstances, be sufficient to conclude that the person has exercised in that state an authority to conclude contracts in the name of the enterprise. This excludes the disclaimer for the right of the agent to conclude contracts. As per international norms, this rule weakens the underlying concept of PE by making every transaction beyond a simple shipment of goods a PE.<sup>15</sup> Moreover, even a person authorised to negotiate the essential elements of a contract and not necessarily all the elements and details of the contract on behalf of a foreign enterprise, can be said to exercise the authority to conclude contracts. This makes the definition of agency PE broader, implying that a foreign enterprise could constitute a PE in India on account of regular solicitation of orders by the dependent agent.

Indian tax authorities have often taken divergent stands in determining the creation of an agency PE. It is often difficult in reality to segregate the responsibilities and activities of an enterprise in watertight compartments so that they fall outside the definition of an agency PE. This creates operational difficulties for businesses and gives the tax authorities liberty to assume that an agency PE exists on the basis of flimsy evidence only to ensure its tax rights. It was pointed out that there is often a difference in the understanding of the concept of PE between the taxpayer and the tax authorities. The latter treats a wholly owned subsidiary with 100 percent ownership of a foreign parent as a dependent agent. Besides, if the Indian business entity provides marketing support to the foreign parent, they presume the Indian entity to be securing orders or concluding contracts on behalf of the foreign parties. These misinterpretations result in harassment of both foreign and Indian enterprises.

For instance, in the case of *Rolls Royce Plc vs. Deputy Director of Income Tax* (reported in [2008]19SOT42 (Delhi) and (2008) 113TTJ(Delhi)446), the Indian subsidiary of Rolls Royce entered into an agreement with the parent company to provide liaison activities (and hence, activities that were preparatory and auxiliary in nature). Tax authorities claimed that the Indian subsidiary was acting as a dependent agent of the foreign company and concluding contracts on its behalf. The Delhi Tax Tribunal, however, held that the activities of the Indian subsidiary were purely in the nature of liaison activities with no evidence to confirm that the Indian subsidiary was concluding/negotiating contracts on behalf of the foreign company in India. Thus, the claim of Indian tax authorities that the Indian subsidiary was acting as a dependent agent, probably only because it was the subsidiary of the foreign enterprise, with no significant proof to confirm the claim, imposed an unnecessary cost burden on the business.

**Service PE:** A service PE is said to be constituted in India if its employees provide service for a period of 180 days to a foreign enterprise that does not have a fixed place of business. This threshold of 180 days is lower than in other countries. India does not follow the interpretation given in Para 42.14 and 42.15

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15 Ernst & Young (2008) “International Taxation in India, Issues and Concerns - Background Research Paper.”

of the OECD commentary that a service PE will be created only if services are performed in the source state. It is of the view that furnishing of services is sufficient for the creation of a service PE. The Supreme Court, in the case of Director of Income Tax (International Taxation) vs. Morgan Stanley & Co. (reported at [2007]162TAXMAN165(SC) and (2007)7SCC1), held that if the foreign entity was responsible for the work of the deputed employee and they continue to be on its payrolls and hold a lien on their jobs, it would have a service PE in India.<sup>16</sup> However, there are inconsistencies in the interpretation and judgements of courts. In another case of AT & S Pvt. Ltd.,<sup>17</sup> the AAR held that payments made to the parent company for secondment of employees to its Indian subsidiary were in the nature of “fees for technical services” and there would be no service PE on this account.<sup>18</sup>

India also does not follow the interpretation given in Para 42.18 and 42.46 of the OECD commentary. It is of the view that taxation rights may exist in a state even when services are furnished by non-residents from outside that state. This taxation principle is different from that applicable to the profits from sale of goods.

**Liaison Office (LO):** The Indian Exchange Control Regulation defines a liaison office (LO) as a place of business that acts as a channel of communication between the principal place of business or head office and entities in India but that does not directly or indirectly undertake any commercial, trading or industrial activity. Further, if the entity is engaged in preparatory and auxiliary activities, it does not constitute a PE.

Since the LO is not permitted to earn any income, it does not constitute a taxable entity in India. However, it is required to withhold tax from certain payments and is expected to comply with the requisite “tax withholding” obligations under domestic tax law. Even though the Reserve Bank of India (RBI), which monitors activities of LOs on an annual basis, has not detected any discrepancy in their working, tax officers at the lower level treat these offices as PEs of foreign entities. It is contended by tax officers that it is often difficult to distinguish between activities that are preparatory and auxiliary and those that are not.

India has further expanded the scope of activities that are not auxiliary to include advertising, supply of information and scientific research. In this regard, India again differs from the OECD practices, and is of the view that the use of facilities for delivery of goods or maintenance of stock of goods for delivery, captive R&D subsidiaries, and negotiation of contracts for the import of products or services into that country results in a PE.

**E-commerce:** The concept of what constitutes a “place of business” has been constantly evolving in tandem with changes in the method of conducting business activities. Perhaps the biggest change in recent times has been the strong emergence of “e-commerce” as an accepted method of doing business. It has provided a means for businesses to operate in a territory without establishing any physical presence. This has rendered the earlier concept of PE obsolete, necessitating a relook at the concept itself. Courts in India have been conscious of this change, and have accordingly tried to interpret the term “place of business” in the light of the new dynamics of commerce. For example, the Delhi Tribunal recently held in the case of Amadeus Global Travel Distribution SA vs. DCIT (reported in (2007) 113 T TJ 767) that a fully automated computer reservation and distribution system (CRS) through which airline reservations were made, installed in the computers of subscribers, would constitute a fixed place of business for a Spanish company in India.

<sup>16</sup> A.A.R. NO. 661 of 2005.

<sup>17</sup> A.A.R. NO. 670 of 2005.

<sup>18</sup> 287 ITR 450 (AAR).

It is not yet fully established whether a website would constitute a PE. Tax authorities globally often overcome this by adopting some sort of presumptive taxation mechanism but none such mechanism is available in India at present. A parallel on the subject could be drawn from Circular no. 742, May 2, 1996, of the Central Board of Direct Taxes (CBDT) in India. In these guidelines, CBDT laid down that in cases of foreign telecasting companies that do not have any branch office or PE in India or do not maintain country-wise accounts, the tax assessing officers shall compute their income by adopting a presumptive profit rate of ten per cent of the gross receipts meant for remittance abroad or the income returned by such companies, whichever is higher and subject the same to tax at the prescribed rate. This rate was subsequently reduced. A recent decision of the Income Tax Appellate Tribunal (ITAT) in the case of Right Florists Pvt. Ltd. (reported on [2013]143ITD445(Kol)),<sup>19</sup> stated that virtual presence through websites does not result in creation of a PE in India under the Act or under DTAA because the server on which the website is posted is located outside India. Hence, payments to search engines such as Google or Yahoo for online advertisements cannot be taxable in India.

Most developed as well as developing countries (including the USA and the UK) are grappling with taxing transactions conducted through the net. The UK is facing trouble with Amazon's UK subsidiary that is routing billions of pounds from sales to British customers through Luxembourg, paying little by way of tax in the UK.<sup>20</sup> Apple is under scrutiny in both the US and Italy for evading millions of dollars in taxes by applying tax strategies such as booking profits in subsidiaries located in low-tax countries. In order to address this problem, the Italian government has proposed a provision, dubbed the "Google Tax", making it obligatory on companies that advertise and sell online in Italy to do so only through agencies with a tax presence in the country.<sup>21</sup> This proposal would not tax the e-commerce giants directly but would force them to use Italian companies to place their advertisements rather than doing so through third parties based in low tax countries such as Luxembourg, Ireland, etc.

The above discussion clearly brings out the uncertainties in the treatment of PE not only by tax officers but also by appellate authorities including the AAR. Tax officers are of the view that unless they look into the facts of the case, they cannot determine if there is a PE or not. While this is not incorrect in its entirety, it creates doubt for businesses and delays the decision-making process, pointing to the need for greater clarity with precise guidelines that bring consistency in the interpretation of tax laws. This will ensure not only greater certainty and limit subjectivity but also help taxpayers make sound investment and business decisions about the enterprise.

**(ii) Attribution of Profits:** The other issue central to the concept of PE is the attribution of profits to the PE. This debate particularly arises in the case of an agency PE where the agent is only partially participating in determining the terms and conditions for a contract but refers back to the parent for concluding the contract and taking all major decisions that require expertise.

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19 <http://itatonline.org/archives/index.php/ito-vs-right-florists-pvt-ltd-itat-kolkata-advertisement-charges-paid-to-google-yahoo-is-not-chargeable-to-tax-in-india/> accessed on 25-9-2013

20 Amazon UK paid GBP 2.4 million tax in 2012 despite sales amounting to GBP 4 billion (Source: BBC News <http://www.bbc.co.uk/news/business-22549434>)

21 Italy approves 'Google Tax' for internet companies' published in Live Mint on December 24, 2013 available at <http://www.livemint.com/Consumer/dNImmmfDsB1O9p6Cum7vkM/Italy-approves-Google-Tax-for-Internet-companies.html>

Although commentaries and international case laws provide reasonable certainty with respect to the existence of a PE, there is no authoritative rule for computing its profits. Agreements aimed primarily at minimising double taxation have been blunted by provisions relating to the determination of profits attributable to a PE (Article 7 of India-US tax treaty and OECD model treaty).

Article 7(1) of the OECD model treaty allows the source country to tax the “profits of an enterprise” but only so much as is “attributable to” the PE in the source country. Two questions then arise – what are the profits to be attributed and how should they be attributed? Two broad interpretations are most commonly used by OECD Member countries.<sup>22</sup> The first is the ‘relevant business activity’ approach that defines the profits of an enterprise as referring to the profits of the business activity in which the PE has direct participation. This approach limits the profits that could be attributed and cannot exceed the profit that the whole enterprise earns from transactions with third parties and those from controlled transactions with an associated enterprise. The second approach is the “functionally separate entity approach”, under which the profits to be attributed to the PE are the profits that the PE would have earned at arm’s length prices had it been a separate and distinct enterprise performing the same or similar functions. This rule ensures that there is no ‘force of attraction’<sup>23</sup> resulting from the existence of a PE. This clause restricts the scope and right of the source country to tax the profits of the PE. It further eliminates the risk of taxation of cumulative profits derived from all operations of the foreign business in the country and not just the PE in case the force-of-attraction rule applies.

The separate entity approach was indirectly accepted by the CBDT in circular no. 740 (April 17, 1996), which stated that the branch of a foreign company is a separate entity for purposes of taxation and clarified that interest paid/payable by the branch to the head office would be liable for tax in India and is governed by Section 115A of the Income Tax Act. Recently, the Supreme Court of India addressed the applicability of the force-of-attraction rule in the context of the India-Japan DTAA treaty and its impact on attribution of profits. In *Ishikawajima-Harima Heavy Industries Ltd. vs. Directorate of Income Tax* (reported at [2007] 158 TAXMAN 0259 (SC)),<sup>24</sup> the Supreme Court observed that there must be a connection between the PE and the transaction sought to be taxed to attract the tax statute. If income arises without any activity of the PE, even under the DTAA, tax liability in respect of overseas services would not arise in India. “Effectively connected” and “attributable to” are to be construed differently. While laying down these rules, the Supreme Court noted the following fundamental principles for attribution of profits:

“What is to be taxed is profit of the enterprise in India, but only so much of them as is directly or indirectly attributable to that permanent establishment. All income arising out of the turnkey 11 project would not, therefore, be assessable in India, only because the assessee has a permanent establishment.”

The acceptability of the separate entity approach for attribution of profits is a positive and significant development marking the alignment of India’s tax rules with international norms. It helps minimise ambiguity surrounding a PE. However, tax professionals during a recent Confederation of Indian Industry (CII)-Ernst & Young Global Tax Summit held in 2013 stated that the attribution of profits to an agency PE is still grey,

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22 OECD Discussion Draft on the attribution of profits to permanent establishment.

23 Force of Attraction Rule states that when an enterprise setups a PE in another country, it brings itself within the fiscal jurisdiction of that other country to such a degree that such other country can tax all profits that the enterprise derives from that country - whether through the PE or not. Therefore, under the ‘force of attraction rule’, the mere existence of a PE in another country leads all profits derived from that other country being treated as taxable in that country.

24 Details available at: [http://law.incometaxindia.gov.in/Directtaxlaws/act2005/%5B2007%5D158TAXMAN0259\(SC\).htm](http://law.incometaxindia.gov.in/Directtaxlaws/act2005/%5B2007%5D158TAXMAN0259(SC).htm)

especially in cases where the agent is not participating in deciding all the terms and conditions of a contract. This needs to be addressed more clearly by the income tax authorities in India.

## 5.2 Transfer Pricing (TP):

Transfer Pricing (TP) is one of the most highly debated topics among tax professionals and tax authorities. In the case of India specifically, discussions have increased following the slapping of tax demands of Rs. 37 billion and Rs. 50 billion on Vodafone and Shell respectively by the income tax department recently. Broadly speaking, TP refers to the practice of arm's length pricing of transactions between group companies based in different countries to ensure that a fair price – one that would have been charged to an unrelated party – is levied. If this is not done, manipulation of prices by group companies in cross-border transactions results in erosion of tax revenues and hence, raises alarm among tax authorities. As MNEs establish a footprint in the Indian business arena, cross-border transactions among group companies spanning multiple tax jurisdictions have increased. There is a risk that these MNEs could shift profits earned in the source country to low tax jurisdictions even if the MNE carries out little or no business activity in that jurisdiction. This results in trade as well as tax distortions and necessitates the need for TP regulations to determine the arm's length character of these associated enterprises.<sup>25</sup>

The explanatory memorandum to the Finance Bill (2001) details the need to introduce TP provisions in India. Sections 92 to 92F under Chapter X of the Act together with Rules 10A to 10T of the Income Tax Rules, 1962 (“the Rules”) constitute the TP provisions. These provisions were introduced with effect from April 01, 2002, through the Finance Act, 2001, and are based on OECD guidelines. They define the meaning of associated enterprise, international transactions, methodology for determining arm's length price (ALP)<sup>26</sup> and maintenance of information and documents by persons entering into international transactions. They also require that persons entering into such transactions furnish a report from an accountant. Further, it lays out the procedure to be followed by assessing officers for making a reference to the TP officer (TPO) and the process to be followed by the TPO to determine the arm's length character of transfer prices.

Indian revenue authorities are reckoned to be among the toughest globally on TP matters, with cases in India accounting for about 70 per cent of all global TP disputes by volume. The number of cases in India is much higher than in countries such as the US, which has only six pending TP cases in litigation, and Singapore, Germany and Taiwan, which have none. India also has the highest number of disputes under the Mutual Agreement Procedure (MAP). Out of this, the maximum number of cases involves US companies followed by UK, German and Japanese companies. It is reported that out of a total TP related tax demand of Rs.70,000 crore raised in FY2012-13, nearly Rs.60,000 crore relate to US companies. These disputes are likely to multiply as the government introduces changes in its regulations, including widening the definition of the term ‘international transaction’ to include specified domestic transactions, and imposing onerous reporting requirements.

Although Indian TP regulations have been amended over the years and have incorporated the latest provisions such as the safe harbour rules and advance pricing agreement (APA) (discussed in detail in sections

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25 “Transfer Pricing: Keeping it at arm's length”, OECD Observer (2002).

26 Arm's Length Price (ALP) means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprise, in uncontrolled conditions (Source: Section 92F(ii), Income Tax Act of India).

below), there are some key TP regulation-related challenges that international businesses, including US companies, face in India and about which they have complained through various channels.

The first is the application of the arithmetic mean to determine the ALP. The Finance Act (2001) lists six methods to determine an ALP for international transactions. In cases where more than one price is determined by the most appropriate method (MAM), the arm's length price shall be taken as the arithmetical mean of such prices. As a statistical technique, arithmetic mean is easily distorted by extreme values in the sample and, therefore, is not considered a reliable measure. Besides, there is lack of sufficient data in India for selecting comparable companies and estimating comparable prices. Even when this information is available, there are numerous problems in validating the data for comparability and making necessary adjustments for differences. Under these circumstances, other statistical measures such as median and quartiles, which are less influenced by extreme prices, may be better alternatives to determine the ALP. Although OECD guidelines do not recommend any particular method to determine the arm's length price, the USA and Mexico follow the inter-quartile range, where the lowest 25 per cent and the highest 25 per cent prices are ignored when determining the ALP.

The second is the acceptance of +/-3 per cent variation between the ALP and the international transaction price. According to the provisions of the Finance Act, if the variation between the arithmetical mean of the ALP determined by applying the MAM by the TPO and the international transaction is within +/-3 per cent, then the price declared by the taxpayer is accepted to be at arm's length. However, in case the TPO determines the ALP for the transaction to be beyond +/-3 per cent, then adjustment is made based on the entire difference between the transfer price and the ALP, without giving any benefit in the range of +/-3%. Moreover, the variation range, which was earlier +/-5 per cent, has been reduced to +/-3 per cent from April 1, 2013, making the provision more stringent. The income tax department has also prescribed a lower limit of 1 per cent for wholesale traders; however, there is ambiguity about the definition of 'wholesale traders' which has not been defined under the Act (KPMG, 'Transfer Pricing' July 2013). Although Rule 10B(2)(d) of the Income Tax Act (1962) makes a reference to wholesale markets in the context of comparability of international transactions, no clear definition is provided. While the basic concept and reference of 'wholesale' trade is widely understood, there is a possibility of questions being raised on whether sales made to industrial or business users can be considered as 'wholesale trade'.<sup>27</sup>

The third is using the cost plus method (CPM), usually claimed to be high and unreasonable by the taxpayer. In certain types of transactions, the Indian entity of an MNE merely acts on the directions of the foreign entity, which provides the taxpayer with all relevant information, intangibles such as design etc. and assumes all the risks of the work. The average mark-up in industry using the cost plus method is between 10 to 20 percent. However, Indian tax administrators apply a mark-up for captive Information Technology (IT) and Information Technology-enabled Services (ITeS) captive service providers of up to 40 per cent of the total cost as against the 13 per cent to 20 per cent claimed by taxpayers. This high mark-up has serious cost implications for the cash flow of taxpayers and creates uncertainty for them.

The fourth is the aggregate versus transactional approach. Under the Transactional Net Margin Method (TNMM), suggested by the Income Tax Act, the taxpayer has to apply the method on a transaction-to-

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27 Tolerance band for Financial Year 2012-13 notifies – 3 percent for all cases other than Wholesale Traders', KPMG Flash News, KPMG India published on April 23, 2013.



transaction basis. Rule 10A(d) of the Income Tax Act states that a “transaction” includes a number of “closely linked transactions”. However, it does not provide any specific guidance or examples on what constitutes closely linked transactions or instances under which an aggregate or a transactional-based approach may be applied for determining the arm’s length character of international transactions. The lack of guidance has led to disputes between the taxpayer and the tax authorities since TPOs apply either of the two approaches arbitrarily, without taking into consideration commercial realities or the business model of the taxpayer. It was pointed out in discussions with stakeholders that despite the provisions in the Act, the authorities often show reluctance to regard a group of transactions as closely linked, especially when treating them as independent transactions results in a higher ALP.

The fifth is the use of data for multiple years. As per the rules, comparability of uncontrolled transaction with an international transaction must be done using data of the financial year in which the transaction occurred. However, data relating to earlier years prior to the financial year may be also considered if such data could influence the determination of transfer prices of the transaction being compared. This ensures that outcomes are not influenced by abnormal factors and reduces the likelihood of anomalous transactions distorting the ALP. This is an acceptable practice in US and Australia and is recommended by OECD. However, there are no clear guidelines in India on the use of data for previous years for comparability. The absence of such guidelines leaves scope for dispute and disagreement between taxpayers and tax authorities. TPO when analysing the data and the transaction at a later date may have access to the relevant financial year data that the assessee at the time of preparing contemporaneous documentation did not. Although, the Indian TP provisions have been amended and taxpayers having international transactions have been allowed two additional months for filing of the Accountant’s Certificate to use the financial data of companies for the relevant assessment year, this time period is too short as the public databases are not updated within two months of the company’s filing their financial information with the government department. Further, use of single year data does not take into account the business cycle of the comparable companies. Accordingly, the CBDT must accept the commercial realities and amend the rules to allow this flexibility for using data of two previous years for analysing comparability.

The sixth is the selection of comparables. TP is fact based and more often than not has to rely on third party comparables to justify the ALP. Therefore, it is fairly common for both the taxpayer and the TPO to accuse each other of cherry picking certain comparables to suit a situation. This leads to TP disputes. In a recent case, a contract software developer, who bears no risk and develops software according to specifications provided by the US parent, was compared with Infosys India, a full-fledged software developer bearing all risks and earning huge profit margins. In many other instances, differences in correct application of adjustments to data of the taxpayer and that of the comparable case occur between the authority and taxpayer. There is often absence of critical data (such as gross profit) of the comparable that creates hurdles for the taxpayer making the comparison for computing transfer price.

The seventh is the recent contention of TPOs of businesses enjoying a location advantage. The TPOs have been justifying higher mark ups in certain cases on the grounds that MNEs benefit from location advantages by relocation of business from ‘high cost’ to ‘low cost’ locations and from ‘location specific advantages’ such as the availability of skilled manpower, large customer base, superior network etc. In doing so, TPOs do not account for the commercial realities that foreign enterprises have to deal with when conducting business in India. The local advantage issue has been explained in detail in the OECD’s revised discussion draft on in-

tangibles, which states that no adjustment on account of location savings is required as all comparables are exposed to the same circumstances and have the same advantages. Moreover, quantification and allocation of location savings is a subject of controversy since it depends on functional analysis and the bargaining power of the two parties involved in the transaction.

The eighth is the disallowance of excessive advertisement, marketing and promotions (AMP) expenses undertaken by Indian affiliates of MNEs. Tax authorities state that any excess AMP expenditure incurred by an Indian affiliate over and above the bright line (the average AMP expense incurred by comparable companies) leads to promotion of the foreign-owned brand. TPOs contend that the associated enterprise of the taxpayer should reimburse these expenditures along with a mark-up as such expenditure is equivalent to a service being rendered by the Indian company to the associated enterprise. This view point has been upheld by a special bench of the ITAT in the case of LG electronics. However, in a recent judicial pronouncement in the case of BMW, the ITAT has stated that if it can be demonstrated that such reimbursements have been received by way of reduction in the purchase price of the taxpayer, then no separate reimbursement is required.

The ninth is the disallowance of royalty payments and management charges by an Indian entity to its associate foreign enterprise on an ad-hoc basis. It was mentioned during stakeholder meetings that while doing so, the TPO often does not take into account the business model followed by the taxpayer and the benefits derived by the taxpayer through the technical know-how, intellectual property and management guidance provided by the associated enterprise. Even though several recent judicial pronouncements have been in favour of the taxpayer, TPOs continue to question the need for payment of royalty and management charges, disallowing them during assessment proceedings.

The tenth is treatment of capital infusion in Indian entity as income. Recently, Shell India was slapped with a tax demand of Rs. 50 billion on accusations of under pricing an intra-group share transfer and consequently evading taxes. The issuance of shares by the Indian entity to its group entity was re-valued from Rs 10 per share to Rs 180 per share. The difference between the actual share price and the price of the share so determined was added to the income of the foreign company that was revised to Rs. 150 billion in the draft order. Further, this shortfall was considered as a loan by the taxpayer to the foreign company and the deemed interest on the amount was brought to tax. Shell contested the order, arguing that taxing fresh equity injection is in effect a tax on FDI. This brings to light another pertinent drawback of Indian TP regulations, which lack clear guidelines on taxation of such capital infusion.

Almost all stakeholders unanimously felt that the underlying problem in India is not the provisions relating to TP regulations but its misinterpretation by tax officials. These officials usually lack specialised knowledge to deal with the complexities of TP. They also do not have an understanding of business dimensions and operations. They have a pro-revenue and anti-taxpayer attitude that leads them to harass foreign enterprises that otherwise are fuelling investment in the economy. Most foreign entities are concerned with the lack of clarity on how transactions will be treated by the TPOs. Since there are no detailed guidelines laid down with suitable examples by the CBDT, the TPOs take an independent stand, resulting in disputes and extended litigation.

The government has made an attempt to reduce TP-related litigation and bring in clarity on taxation of transactions through the introduction of APA and safe harbour rules. The APA is an agreement between the taxpayer and tax authority concerning the TP method functional to a company's inter-company transactions. Through this, the tax authority accepts not to look for TP adjustment for enclosed transactions as long as the taxpayer obeys the terms and conditions agreed under the APA.<sup>28</sup> The APA can be unilateral, i.e. between the government and the taxpayer or bilateral i.e. between governments of two countries or even multilateral i.e. between governments of more than two countries. Introduced under the Finance Act 2012, the APA has garnered a lot of positive feedback, generated a positive sentiment in the business community and reduced the risk of double taxation. The concerned tax authority has already received 149 unilateral and 29 bilateral filings. However, no APA has been finalised and signed so far.

Provisions relating to safe harbour rules first came to the forefront under the Finance Act 2009 but were notified only in September 2013. Safe harbour rules, a credible alternative to APA, lay down the framework under which the transfer price prescribed by the assessee will be accepted by the tax department for five assessment years. Under these rules, ratios for eligible international transactions based on industry sectors are provided. For instance, with respect to software development or IT services, the safe harbour ratio for operating profit margin-to-operating expense can be 20 per cent or 22 per cent (depending on the aggregate value of the international transactions). This aims to reduce aggressive scrutiny by the tax department. As a boost to the IT and ITeS sector, the government has also relaxed the transaction limit to Rs.500 crore for availing safe harbour regulations, making it more palatable for large IT services firms, including Knowledge Processing Outsourcing (KPO) and Business Process Outsourcing (BPO) units.

Safe harbour rules are generally considered inconsistent with ALP and imply a premium over ALP, which taxpayers would be willing to pay for immunity from tax litigation and simpler compliance. The general feeling within industry, however, is that the profit margins notified for various categories are higher than that applied by comparables. While taxpayers with small-scale operations may opt for safe harbour rules, companies with large transactions may not as the premium on margin would entail huge incremental tax payments. Further, safe harbour at such high margins would be difficult to align with the global transfer pricing of MNEs. In such cases, companies may opt for APA. While bilateral APAs would mitigate the risk of double taxation, safe harbour rules might not. Unlike APAs, safe harbour rules require detailed documentation. The characterisation of transactions into various categories could also lead to subjective interpretation. While rules define eligible taxpayers, eligible transactions and various categories of transactions and services, there is only a thin distinction between ITeS, KPO and contract R&D for software development. Since different rates have been prescribed for different categories, any inappropriate classification could have large tax implications. Although the Rangachary Committee recommended that these rules should have no implications for taxpayers who do not opt for the safe harbour rules and have an ALP below the safe harbour rates, there is a feeling that taxpayers would rather opt for APAs than go for safe harbour rules.

While both APA and safe harbour rules have been received well by industry, it remains to be seen how beneficial the two instruments prove to be for the investor and taxpayer. It is expected that most corporates with small TP cases would resort to safe harbour rules and most large TP cases will use APA. Overall, both these instruments are a welcome response from the government and are likely to lower TP-related tax disputes.

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28 [http://www.transferpricing-india.com/Advance\\_price\\_agreement\\_APA.htm](http://www.transferpricing-india.com/Advance_price_agreement_APA.htm) accessed on November 26, 2013.

## 5.3 Dispute Resolution:

Litigation is a pressing concern for all corporates in India and a consequence of tax uncertainty, inconsistent application and law-related ambiguity. A number of cases that have emerged in the recent past have drawn media attention globally and alarmed foreign investors. While tax disputes related to interpretation and application are inevitable in many jurisdictions, what makes the experience especially frustrating in India is the incapability of the system to resolve them expeditiously without resorting to a prolonged and expensive litigation process. This leads to the global perception that India is a difficult jurisdiction to operate in or to do business with.

India has a four-tier dispute resolution mechanism. If a taxpayer is not satisfied with the assessment, he/she can file an appeal with the Commissioner of Income Tax (Appeals) (CIT (A)) and thereafter, file a second appeal to the Income Tax Appellate Tribunal (ITAT). The decision of the ITAT on a question of fact is considered final and an appeal can be made to a high court or the Supreme Court on any question of law arising from such an order. There are two inherent weaknesses in the Indian dispute resolution mechanism that are discussed below—the time and cost involved and the anti-taxpayer attitude of the tax administration.

**(i) Time Consuming and Costly:** India has an extremely time-consuming appellate process. The statute for disposal of appeals prescribes a time limitation of one year for CIT (A) and four years for the ITAT. However, the time limitation is only directory and not mandatory. There is a huge backlog of appeals with various appellate authorities. It was pointed out by stakeholders that it takes 15 to 20 years for cases to get resolved in India compared to 3 to 4 years in many other developed and developing countries. The problem of pendency of cases is not only at the appellate level but also at the assessment level, largely due to a plethora of unwarranted cases picked up for scrutiny. A study by Chattopadhyay and Das-Gupta (2002)<sup>29</sup> states that anecdotal evidence suggests that the department files second appeals to avoid sanctions for lack of due diligence during external audits by the Comptroller and Auditor General (CAG) of India.

Moreover, India does not have sufficient case law in international taxation to serve as judicial precedents. Although the Supreme Court has upheld the applicability of international commentaries and decisions as case law, income tax authorities are unwilling to recognise them. This consequentially makes obtaining a stay order on the tax demand of authorities difficult for the taxpayer.

**(ii) Anti-Taxpayer Attitude of Tax Administration:** It was pointed out during stakeholder consultations that Indian tax authorities hold an anti-taxpayer and pro-revenue attitude during the dispute resolution process. Different officers at different levels give conflicting rulings and interpretations of the same issue. Unlike in most developed country tax administration, disputes are not resolved at the tribunal level and dragged to courts. The administration does not prefer amicably resolving dispute through arbitration. This lengthens the process for the taxpayer who bears the high costs of litigation.

Apart from the regular appellate procedure, MNEs in India have other avenues for dispute resolution. These avenues were set up based on international best practices to fast track the process of resolving international

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29 Chattopadhyay and Das-Gupta, 2002. “The Income Tax Compliance Cost of Indian Corporations”, National Institute of Public Finance and Policy.

taxation related litigation. Unfortunately, each of these is characterised by limitations that make the system dysfunctional.

**Dispute Resolution Panel (DRP):** To resolve TP related cases, a Dispute Resolution Panel (DRP) was introduced in India consisting of three Commissioners/Directors of Income Tax. Under this mechanism, tax authorities make adjustments to the ALP in relation to transactions with overseas affiliates. This mechanism, applicable to both Indian and foreign companies, has been introduced at the assessment stage itself to provide businesses with a time-bound alternative to the appellate route through the CIT (A). The DRP has a specified time frame of nine months and has wide powers to confirm, reduce or enhance additions proposed in a draft order. The assessee has a right to go in appeal against assessment orders passed under the direction of the DRP to the Tribunal.

Based on American provisions, the DRP was set up in India to independently resolve TP related cases. In the US, authorities handling such cases are kept autonomous of the IRS and approach the matter to arrive at a settlement with the taxpayer after carrying out a probability analysis of the case if it goes to court. This results in very few cases landing in law courts. On the other hand, in India, the DRP consists of officials from the CBDT, making the procedure biased and unfair. There is also a trust deficit – taxpayers carry the impression that DRP does not approach the problem independent of the tax authorities. This impression is partially based on the way in which the DRP is constituted. An attempt has been made to remedy this problem by ensuring that no member from the tax department of the city where the assessment is being made is part of the DRP. There have been suggestions to replace the DRP with a permanent body headed by a high court judge.

Moreover, since the DRP's directions are not binding on both parties, they have no finality. Earlier the tax officers had no right to appeal against the orders of DRP. However, this has now been amended and the tax officer has been given the right to challenge the order of DRP before ITAT. This implies that orders issued by the DRP are open to challenge through the entire appellate structure except the CIT (A). This is a retrograde change as in most developed countries tax officers are not allowed to appeal against the orders of higher tax authorities which in this case is orders of a panel of three Commissioners of Income tax. The CBDT Board, while acknowledging that the existing appellate structure results in time-consuming and long drawn out procedures, has suggested the same appellate structure for appeals against the orders of the DRP.<sup>30</sup> This is unlikely to resolve the problem as delays in the appellate machinery takes place not at the CIT (A) level but at the higher appellate level. This means that the problem of prolonged litigation is likely to remain. The only silver lining is that the taxpayer can file an appeal straight away against the assessment order to the Tribunal and seek a stay order.

It was repeatedly mentioned during stakeholder consultations that although the DRP was expected to be a ray of hope, it has not managed to fulfil its original promises. There is lack of accountability and no measure of its performance. Consequently, there is no incentive for the panel to take a stand and resolve cases without expensive litigation. Besides, the fact that the assessing officer (AO) can appeal against the order of the DRP adds to its weakness and makes it misaligned with international best practices.

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30 S.S. Khan (2011) "Will Dispute Resolution Panels really be able to resolve disputes?", Tax India International accessed on November 30, 2013.

**Mutual Agreement Procedure (MAP):** MAP is a dispute resolution procedure provided under DTAA. Under this, a taxpayer can approach the competent authority (CA) of its country when it holds the view that actions of tax authorities in either or both countries will result in a tax incidence contrary to treaty provisions. When accepted, the application is sent to the CA of the other country. The settlement is usually achieved through negotiations between the two CAs and any decision undertaken is binding on the tax authorities of both countries. If the settlement is acceptable, the taxpayer gives up any right of appeal on the issue. Once the negotiated settlement is reached, the dispute can subsequently be withdrawn from the formal legal process.

Many US and non-US companies with business operations in India are invoking the MAP, especially to contest the amount of tax demanded. Recently, in December 2013, the tax authorities of both USA and India finalised the broad contours for the MAP in an effort to provide a clear framework to international corporates for resolving tax disputes arising from transfer pricing assessment, existence of PE, and characterisation and attribution of profits to PE. However, the MAP has its own inherent problems. This includes the absence of any prescribed time limit for resolving cases.<sup>31</sup> In the recent past, CAs of India and the US have been unable to come to an agreement during negotiations. This has resulted in a gridlock in many cases and a delay of 2 to 5 years. The lack of agreement between the Indian and US CAs, despite frequent discussions, is without precedent. In the interest of US-India bilateral trade and investment, USIBC has urged the Government of India to resolve the current gridlock in transfer pricing disputes in accordance with international norms.

In a significant breakthrough ahead of Prime Minister Manmohan Singh's visit to the US in September 2013, the two countries decided to end their three-year old acrimony and re-start negotiating tax settlements under the MAP. The last CAs appointed in India and US for MAP had differences of opinion in most cases. They have been replaced by their respective governments. These peace moves have raised hopes of expeditious settlement of long-pending tax disputes involving a number of US multinationals in India, helping New Delhi send out the signal of a non-adversarial tax regime and friendly investment climate. In return, the US has assured that it will recognise India's APA, which will encourage more US-based companies to approach Indian tax authorities to know their potential tax liability in advance. This important breakthrough was reached after three days of talks between visiting US tax authorities and Indian tax officials in September 2013.<sup>32</sup>

**Authority for Advance Ruling (AAR):** Under the Income Tax Act (1961), Authority for Advance Ruling (AAR) was introduced with the objective of providing certainty on income tax liability to the taxpayer well beforehand and avoiding the possibility of a long drawn litigation. The Authority can be approached by non-residents as well as residents having international transactions for an advance ruling in respect of transactions they propose to enter into. Although taxpayers have approached the office and filed before AAR, there have been instances of some conflicting decisions even though this has no precedence value. Moreover, the Authority has not been able to dispose-off cases within the six month time limit prescribed for rendering its rulings. There is need to strengthen this mechanism as well.

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31 "India, US preparing for Tax Headache Relief", published in The Economic Times on December 26, 2013.

32 "India, US end three-year-old deadlock; to talk tax issues again", published in The Economic Times dated September 18, 2013.

## RETROSPECTIVE AMENDMENTS TO THE INCOME TAX ACT

In the Finance Act (2012), the Government of India introduced over a dozen retrospective amendments to the Income Tax Act (1961), casting a shadow on the government's intent and leading to apprehensions about the certainty, predictability and stability of tax laws in India. Ostensibly, these amendments were made to clarify and restate the legislative intent of the source rule of taxation for non-residents in India. In particular, they addressed the situation of transfer of assets in India exclusively between non-residents. It was strongly felt that amendments to certain sections (especially Section 9 on indirect transfer of assets<sup>33</sup> situated in India) of the Act were made to overrule the Supreme Court's judgement on Vodafone.<sup>34</sup> While such 'clarificatory' amendments have been issued in the past, it was the sheer numbers carried out through the Finance Act 2012 that was alarming. Although such amendments are intended to clarify existing law, they effectively end up changing the law in favour of ITD.<sup>35</sup>

During the authors' consultation meetings, two areas where retrospective amendments were made through the Finance Act 2012 were unanimously pointed out – royalty on services and capital gains on indirect transfer of shares.

The amendments to Section 9(1)(vi) Explanation 4 to 6 through the Finance Act 2012 retrospectively from 1976 identified payment toward shrink-wrapped software, connectivity charges, transponder hire charges and so on as 'royalty'. This implied that the transfer of all or any right to use computer software, including licensing, would be treated as royalty, irrespective of the transfer medium.<sup>36</sup> Another amendment was made to the definition of 'royalty' to include any consideration with respect to right/property/information irrespective of whether the recipient controls or uses it, or whether it is located in India or outside. Moreover, the definition of the term 'process' was also broadened to include transmission by satellite, cable, optic fibre and so on.

33 Indirect transfer of assets refers to acquisition of assets located in India by foreign entities outside India.

34 Vodafone International Holdings BV versus Union of India & Anr [S.L.P. (C) No. 26529 of 2010, dated 20 January 2012] reported in [2012]107CLA63(SC), [2012]204TAXMAN408(SC).

35 Prateek Andharia (2011) 'The Validity of Retrospective Amendments to the Income Tax Act: Section 9 of the Act and the Ishikawajima Harima Case', NUJS Law Review.

36 "Open source for software taxation", Business Line dated March 13, 2012.

In the case of computer software, a person using the right to replicate off-the-shelf software or shrink wrapped software for replication makes a royalty payment and deducts tax at source. The issue arises as the amendment subjects to tax the payment by the distributor to the replicator for shrink-wrapped software. This is against the underlying concept of royalty. Here, the distributor is not exploiting copyright but is only distributing the product and earning a business income. This has largely affected both American companies such as Microsoft and Motorola, and non-American companies such as Samsung and Nokia.

Another critical issue that arises in the case of software is whether the receipt of payment is for “use of copyright or a copyrighted article”. In the cases of Ericsson (DIT vs. Ericsson AB 343 ITR 370 (Del)) and Motorola (Motorola Inc 95 ITD 269 (Del)), the tax department claimed that payment for software embedded in the hardware should be taxed as “royalty” under section 9(1)(vi) & Article 13 as the software is a ‘copyright’. However, the Delhi Special Branch as well as the Delhi High Court decided in both cases that the software was an integral part of the system with no independent existence and the payment for supply of such equipment cannot be treated as royalty. Further, when put on media in any form, the sale of a copyrighted article is same as sale of goods. Hence, the payment received is of the nature of business income and is not taxable in India in the absence of any PE or business connection. It, therefore, becomes imperative that a distinction be made as to whether the payer of licence fees acquires the right to the use of software alone or has the right to make copies and distribute it to the public. It is also important to consider if the right to distribution is with or without rights to modify the software.

Under most technology agreements, non-residents receive payments net of taxes, i.e., the Indian company pays taxes on royalty. In the case of residents of a non-DTAA country, the payment is subject to a withholding tax of 25 per cent. Similarly, in the case of non-residents earning royalty/fee for technical services (FTS) connected with a PE in India, the applicable withholding tax is 25 per cent. Thus, the cost of importing technology into India has gone up substantially. This is again anti-industry as technology transfer from developed countries to developing countries is central to the latter’s ability to compete in the global economy. It is interesting to note that even under the proposed Direct Taxes Code, the withholding tax rate on royalty is planned at 20 per cent. What, therefore, is required is a clear direction in policy as well as government intention.

A second concern pertains to the taxability of capital gains on indirect transfer of capital assets, even though such transfer resulted ‘by means of’ or ‘in consequence of’ transfer of offshore shares, which derive their value substantially from assets located in India.<sup>37</sup> This particular amendment, being retrospective from the date of enactment, i.e., April 1962, inter-mingled two matters – retrospective applicability of tax laws, and indirect transfer – under the same regulation.

Indirect transfer refers to the sale of assets located in India by virtue of sale of shares in the holding company by an existing investor to another investor. This transaction takes place outside India among foreign entities. It was contended by the ITD that by transfer of shares of the holding company, business assets located in India are also transferred, though indirectly. Hence, the capital gains so arising should be taxable in India.

To restore investor confidence, an expert committee was set up by the Prime Minister under the chairmanship of Dr. Parthasarathi Shome, which looked into the matter, consulted stakeholders and suggested recom-

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37 ‘Budget 2012: Retrospective Amendments steal the thunder’ BMR Advisors.



mendations. Stakeholders submitted their concerns, pointing out that the retroactive amendment relating to indirect transfer of shares is a violation of Article 14 of the Constitution, which forbids similar treatment accorded to dissimilar persons. This implies that by taxing income accruing from transfer of offshore shares and deeming such shares to be located in India, the amendment sought to obliterate the distinction between a resident and a non-resident. It was also mentioned that a directive by the ITD to deduct tax on a transaction that took place before the date of amendment resulted in a situation of impossibility of performance.

The Shome committee, in its report, stated that the “Taxation of indirect transfer as introduced by the Finance Act, 2012, are not clarificatory in nature”. It recommended that retrospective amendments to tax law should occur in exceptional or in the rarest of rare cases and with particular objectives. It stated that in case the retrospective nature of the amendments is proceeded with, no burden should be fixed on the payer for not withholding taxes since the same would result in ‘impossibility of performance’. In any case, if the amendments were to be introduced, the committee was of the view that capital gains should be made taxable on account of retrospective amendments but no penalty and interest should be levied in respect of the income brought to tax on the application of retrospective amendments. One important suggestion of the expert committee was that the phrase “directly or indirectly” be clarified to represent a “look through” approach. By implication, this meant that to determine the value of a share of a foreign company, all intermediaries between the foreign company and assets in India may be ignored. Finally, the expert committee was of the view that, as a matter of policy, the government should best avoid introducing fundamental changes in tax provisions without consultation with, and hence not anticipated by, the taxpayer.

Retrospective amendments are not uncommon. In countries that follow the Westminster system of government (such as UK, India, Canada, etc.) ex-post facto law is technically possible through the power vested in Parliament by the doctrine of parliamentary supremacy. In UK, the government introduced the Finance Act 2008 through which it retrospectively changed the law to target tax avoidance schemes. This was done to find a solution to the impasse where a UK court of appeal had in 1989 upheld the decision of a lower court to quash the decision of the UK tax department to tax a UK resident’s earnings through an offshore partnership based in Jersey. The amendment specifically targeted tax avoidance schemes that made use of offshore trusts and double taxation treaties to reduce the tax paid by the scheme’s users.

Similarly, in India, the legislature does have the power to legislate civil law amendments with retrospective effect. However, against the backdrop of the increasing frequency and number of retrospective amendments carried out in the recent past, it needs to be questioned whether this power can be exercised if the sole motive is to merely overturn the verdicts of courts. While it holds true that the power to retrospectively make amendments is essential in contemporary tax regimes, the manner, method and frequency of these amendments in India is nevertheless disturbing. It is essential to bear in mind that no agency and authority should be allowed to try to achieve indirectly something that is otherwise directly forbidden. This is primarily so because in a democratic setup as in India, such retrospective amendments tend to disturb the balance of power.

USIBC has urged the India government to ensure that any changes to India’s tax law should not be retrospective. The government should also provide a clarification that recent changes to the law will be legally binding and not subject to arbitrary application. While assurances have been given on the retroactivity of certain provisions affecting indirect share transfers and software royalties, US companies require predictability and remain concerned about how such assurances will translate into law.

## OECD ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (BEPS)

In recent years, globalisation has led to global integration of economies and corporations at a fast pace. The free movement of capital and labour coupled with removal of trade barriers, shifting of manufacturing base to low-cost locations, and technological developments have changed the ways of conducting cross-border activities. MNEs have shifted from country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional and global level.<sup>38</sup> These MNEs reside, control and manage operations from one country (resident-country) but conduct business in multiple countries (source-country), sometimes without establishing any office in the latter countries. The spread of internet and growth of e-commerce has also made it possible for businesses to locate many of their activities in countries far away from customers to whom they deliver services.

In the presence of multiple DTAA's spanning multiple tax jurisdictions, all of these developments have incentivised and exacerbated sophisticated tax planning activities by MNEs that identify and exploit legal arbitrage opportunities. By taking aggressive tax positions, MNEs are able to legally mitigate or avoid paying taxes in either source or resident country by artificially segregating taxable income from the activity that generates it. This has thrown up challenges of base erosion and profit shifting in the existing tax regime. Governments, both in developed and developing countries, are facing protests from citizens and domestic businesses over inequity and unfairness in a system that enables some highly profitable corporations to pay far lower taxes than some of their own employees.

One of the most commonly cited examples is of Starbucks, which paid no corporate tax in 2009-2011 by reporting losses despite notching up sales of GBP1.2 billion from more than 700 outlets. Another example is of Apple which, despite being the most profitable American technology company, avoided paying billions in taxes in not just the US but also around the world through a complex web of subsidiaries and tax avoidance arrangements. Companies usually go treaty shopping, including placing copyrights in offshore shell companies, and then paying royalties to those shell entities as a way of reducing the stated taxable profits earned in higher-tax countries. In the wake of such strategies, companies that conduct cross-border business have an advantage over those who do not have overseas operations or are not resident in tax ha-

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38 OECD (2013), 'Action Plan on Base Erosion and Profit Shifting', OECD Publishing.

vens. Although tax planning helps MNEs to reduce their tax outgo, this base erosion is detrimental to other sections of society.

Against this backdrop, at the instance of the G20, OECD published an Action Plan listing fifteen new tax principles on BEPS in 2013 with the objective of addressing perceived flaws in international tax rules in a time bound and co-ordinated manner. BEPS Action Plan relates to instances where DTAA and tax rules lead to double non-taxation, or less than single taxation. If adopted widely, it will shift some of the global tax burden from small enterprises and individuals towards large companies. If not accepted, it is feared that countries will resort to unilateral actions that will eventually lead to double taxation and thereby, hamper investments.

The action plan states that fundamental changes are needed for effective taxation and new international standards must be designed to ensure consistency of corporate income tax at the global level. It recognises that actions implemented to counter BEPS cannot succeed without further transparency or certainty and predictability of business. One of the critical points mentioned in the action plan is the challenge of taxing a digital economy. E-commerce and web-based businesses pose difficulties in applying existing international tax rules. The action plan takes a holistic approach to this problem and considers both direct and indirect taxation. The other issue is to develop model treaty provisions and recommendations to design domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. OECD in its report states that there is urgent need to strengthen controlled foreign company (CFC) rules through co-ordinated efforts along with revamping the work on harmful tax practices with emphasis on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. OECD also realises that there is a tendency amongst corporates to resort to artificial avoidance of PE status. The action plan aims to develop changes in the definition of PE and profit attribution. It also states that MNEs have in some instances used or misapplied rules to segregate income from the corresponding economic activity with the purpose of shifting the relevant income to a low tax environment. This most often results from transfers of intangibles and other mobile assets. The plan lays down actions for each of the three identified areas.

In addition, the OECD report lists recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative cost implications for tax administrations and businesses. The report uses a modular design allowing for maximum consistency, keeping in mind country-specific needs and risks. One area of focus is international tax schemes, where further work will explore using a wide definition of “tax benefit” to capture such transactions. This will be harmonised with work on co-operative compliance. Another important focus area of BEPS is transfer pricing documentation to enhance transparency in tax administration, keeping in view the cost of compliance to businesses. The OECD action plan also concentrates on making dispute resolution mechanisms effective and developing a multilateral instrument for resolving international tax disputes.

The OECD action plan has set clear parameters for each action item. At the same time, it leaves considerable scope for the Working Groups<sup>39</sup> to formulate their own recommendations. The actions put forward will take close to two years for completion and perhaps considerably longer to be fully applied in practice.

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<sup>39</sup> OECD Working Groups have been set up to focus on each of the issues listed in OECD BEPS report. Interested non-OECD members of the G20 have also been invited to participate. (Source: Deloitte’s OECD Tax Alert ‘Action plan on Base Erosion and Profit Shifting released’ published on 19 July 2013)

Nevertheless, there are indications that BEPS related developments have already led to a material shift in the behaviour of tax administrations.

Overall, the action plan presents a balanced approach where, on the one hand, it clearly identifies the ‘gaps’ in the current system and puts a roadmap to address these through forming dedicated Working Groups, and on the other hand, sets a responsible tone, stressing the need for formulating guiding principles on transparency, predictability and accountability for both the government and the taxpayer. Price Waterhouse Coopers, in its Tax Policy Bulletin (July 2013),<sup>40</sup> states that it welcomes this approach of building on, rather than abandoning, longstanding rules on international taxation and welcomes, in particular, the statement discouraging unilateral measures to avoid re-emergence of double taxation.

However, some concerns arise over multilateral implementation and harmonisation of diverse tax systems. A case in point is India that has been struggling for almost a decade to pursue domestic tax reforms but has been unable to secure the agreement of all parties. In the wake of such discord, rushing into new multilateral initiatives holds a further risk of causing instability for MNEs. But having said that, as one of the major emerging economies of G20, it is imperative that India actively participates in all discussions of BEPS. Though, in the past, India has been stressing and pursuing a source-based taxation approach, it is about time to revisit this strategy as it transforms from an importer to an exporter of capital and technology. India should make efforts to bring about a balance to its taxation approach and harmonise its processes with international standards. It should attempt to take the lead wherever possible in various Working Groups to not only safeguard its own interests but also those of other developing economies. Absence from such multilateral deliberations would only hurt India more in the long run.

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<sup>40</sup> Pricewaterhouse Coopers, 2013 “OECD’s Action Plan published on Base Erosion and Profit Shifting”, Tax Policy Bulletin published on July 19, 2013 available at [http://www.pwc.com/en\\_GX/gx/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-beps-action-plan.pdf](http://www.pwc.com/en_GX/gx/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-beps-action-plan.pdf)

## CONCLUSIONS AND RECOMMENDATIONS

In the context of the relatively bleak economic outlook for the country, when pessimism about future growth prospects is at its peak, abrupt and unfavourable announcements can have irreparably damaging effects on the Indian economy. As the country struggles to emerge from an economic crisis, ill-considered measures as well as their adverse consequences can seriously hurt investment inflows and investor sentiment.

Since the budget of FY 2012-13, India has seen some significantly controversial developments in tax policy, which have opened old wounds and brought to the surface issues like transfer pricing and dispute resolution that have long disturbed foreign investors. The country has witnessed a substantial rise in policy uncertainty and instability, which has culminated in India being viewed as a difficult jurisdiction to operate in or to do business with. Although tax disputes have had a history in India like in any other country, litigation, in particular in areas of international taxation, has picked up considerably in the last two years after the Supreme Court verdict in the Vodafone Plc case, followed by the retrospective amendment to the Income Tax Act, 1961 through the Finance Bill, 2012. The inconsistent and subjective approach of tax authorities across the country has worsened operating conditions for businesses in India.

Although the availability of qualified and skilled manpower at a reasonable cost, better return on capital and a large domestic market have made India a desirable investment destination, problems of tax administration undermine India's appeal, especially when similarly placed competing countries provide a better investment climate and a more friendly tax administration. India needs to reform its administrative processes and align with international best practices. This requires not just certainty in tax laws but also a more structured explanation of tax policy, laws and rules, so that nothing is left open to interpretation by either tax administrators or taxpayers. Policymakers and administrators must issue detailed guidelines for the implementation of tax law provisions. To reduce litigation cost for businesses, it is necessary to empower the tax authority to expeditiously resolve any contentious issues that may arise.

India has not singled out US companies in its attempt to target MNEs under international taxation norms. But their significant presence, in terms of both number and market presence, has resulted in a large number of these companies facing tax scrutiny and audit. US companies have raised their voice against the Indian

tax authorities and policymakers, indicating that if these circumstances continue to prevail, India will fall out of the mainstream and suffer serious investment consequences.

Tax authorities of India and the United States have recently finalised a framework for negotiated settlements that will enable the resolution of more than 100 tax disputes involving subsidiaries of American multinationals such as IBM, Oracle and Microsoft that face tax claims of millions of US dollars.<sup>41</sup> The Government of India has indicated that the resolution of these disputes, some of them pending for more than three years, could come as early as February 2014. It is hopeful that this will send strong signals to global investors about India's intent to provide a taxpayer-friendly administration.

Given that there is limited room to raise revenue through higher taxes, the Indian government should mobilise its efforts towards introducing third generation tax reforms that focus on re-structuring and modernising the tax administration. This requires simplification of tax laws, improved infrastructure for tax administration, and harmonisation and integration of laws and procedures across the country. A transformation in all these aspects will help reduce not just the compliance cost of the taxpayer but also the administrative burden of the government.

Essential ingredients for tax administration modernisation are superior quality taxpayer information services, automation and standardisation of procedures, avoidance of tax disputes and quick resolution in case these arise. Some of these objectives can be attained through effective use of IT. India has made progress in this area over the last two decades, especially in e-filing of returns and on-line payment of taxes that has picked up pace in the last two years. However, the considerable role that the use of IT can play in comprehensive automation and integration of processes, minimising contact between officials and taxpayers, data collection and analysis for formulating sound policy, and enhancing taxpayer services, has not yet been tapped to its full potential.

The current system of tax administration lacks transparency, which encourages rent-seeking behaviour and diminishes the willingness of taxpayers to voluntarily pay taxes. The decisions, attitude and actions of the Indian tax administration are mostly guided by the assumption that taxpayers are naturally inclined to avoid taxes. This lack of trust between taxpayers and the tax administration needs immediate attention and action. The anti-taxpayer attitude needs to be replaced with a more communicative and co-operative compliance approach. Modern tax jurisdictions such as those in the US, the UK and Australia have adopted a co-operative compliance strategy that treats taxpayers as customers and encourages the adoption of a more customer-centric approach towards taxpayers. Apart from establishing revenue targets, evaluating performance and setting organisational objectives, there is strong emphasis on the parameter of customer satisfaction.

Another beneficial policy is to conduct impact analysis of various legal provisions and regulations before and after legislation is enacted. This has been in practice in both UK and Australia for many years. As a part of responsive regulation, such impact analysis helps keep a check on red tape.

Although tax administrators the world over are frequently blamed for unfair and stringent monitoring practices, it is noteworthy that MNEs globally have resorted to aggressive tax planning by taking advantage of DTAAAs, tax havens and low-tax jurisdictions. While most of these business arrangements are considered

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41 'India, US preparing Pill for Tax Headache Relief', published in The Economic Times on December 26, 2013.

to be legal in form, they are often not in substance. In response to such tax avoiding behaviour, most tax administrations have enacted laws like GAAR to counter such practices.

GAAR per se is not anathema to tax jurisprudence. But in India, it was its sudden introduction with ambiguous provisions and without adequate safeguards that created a storm. To make amendments, the Indian government setup the Shome Expert Committee, which made recommendations after extensive industry/stakeholder consultations. While many of these recommendations were accepted, some were unfortunately ignored. Businesses, nevertheless, have to accept the reality that GAAR will be applicable in India from 2015 in its revised form. Officials from the ITD assured businesses at a recently held Global Tax Summit organised by CII-Ernst & Young<sup>42</sup> that the government would establish sufficient guidelines and safeguards before introducing GAAR.

In the case of PE and attribution of profits to PE, not just tax officers but also the appellate and AAR in India face ambiguities in the absence of any clear guidelines. Though it is noteworthy that PE in itself is an 'ill-defined term',<sup>43</sup> at least some part of the problem can be resolved through clearly formulated directives for interpretation and attribution of profits to PE.

If one looks at the global experience, it is observed that similar issues of TP have risen in several countries. However, the difference in India is the way a case is interpreted by different authorities and the focus of tax administrators on revenue-raising. There have been many cases recently where Indian tax authorities have raised unreasonably high tax demands in the absence of clear guidelines for the taxpayers to interpret tax provisions. There is an urgent need to issue transfer pricing guidelines with examples covering as many situations as possible as well as a list of possible frequently asked questions. The government has partly resolved the problem by introducing APA and the more recent safe harbour rules, both of which have been welcomed by business and industry. A positive step in the direction of international taxation can be the appointment of experienced officials with knowledge of trade and industry to handle transfer pricing cases. Moreover, these officers must be provided with frequent and intensive training to equip them to appropriately handle such cases.

Litigation and dispute resolution is another matter of grave concern for MNEs in India. In spite of a systematic mechanism, it takes unimaginably long to resolve tax matters in India, at a huge cost to companies. India should take a cue from other countries and empower its officials to resolve cases independently of the courts. This will reduce not just the compliance cost of the taxpayer but also the administrative and judicial cost of the government.

Retrospective amendment of law is not an unknown phenomenon. In countries with the Westminster system of government, ex-post facto law is plausible through the power vested in the Parliament. However, when this power is exercised, the sole motive driving it must be checked. In the case of India, when the government introduced retrospective amendments, it was seen to be carried out with the purpose of overturning the decision of Supreme Court in the case of Vodafone Plc. Business and industry questioned such arbitrary amendments to the law and became apprehensive about the possibility of such events occurring in the future as well. This made a huge dent on investor confidence in India.

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42 CII-E&Y 'Global Tax Summit' held on November 20, 2013 in New Delhi, India.

43 'Patch-up Job' published in *The Economist* issue January 25-30, 2014 page 55.

With respect to international taxation, both advanced and emerging economies are facing the problem of base erosion and profit shifting by large multinationals through aggressive tax planning, resulting in double non-taxation or low taxation. To address this problem and pre-empt countries from enacting laws to prevent BEPS, OECD has designed a framework for coordinated multilateral action to address some of the pertinent issues relating to tax avoidance and tax evasion. OECD's BEPS has become a crucial agenda for the G20 Summit scheduled to be held in November 2014 in Australia. Given that India is now emerging as an exporter of capital and technology, there is a strong case for India to play a leading role in the deliberations of the working groups set up for various action plans and in formulating the outcomes to safeguard its unique position in the long run.

As India's competitors in the global markets, such as Indonesia and China, make tax policy, especially the tax administration, investor friendly, it is imperative that India addresses concerns regarding certainty and fairness raised by foreign investors at the earliest. It must adopt some of the promising international practices such as putting proposed legislation in the public domain for extensive consultation, conduct impact analyses of legal provisions both before and after legislation is enacted, and bring out detailed circulars and manuals on procedure, with examples and illustrations, to cover all possible eventualities.

It must be realised by India's political leaders, decision makers and bureaucracy that considerable productive time and effort is lost on matters that can be avoided by clarity in policy formulation and consistency in its implementation. Accordance in some considerable degree with international norms and procedures can greatly help reduce litigation, which is mostly a waste of intellectual capital and financial resources. This will help reduce the current deep-rooted sense of frustration, helplessness and pessimism within the business community, and especially among large multinational companies, which otherwise are used to dealing with more sophisticated and efficiently-run tax administrations.

Although India's general elections are round the corner in 2014, there is a renewed interest from political leaders in long-stalled tax reforms in India. In the last few years, two major tax reforms, Goods and Services Tax (GST) and Direct Tax Code (DTC), have been envisaged which, if implemented, could potentially change Indian tax policy and administration. Both these reforms could bring greater stability and transparency to taxation of businesses, procedures, consumers and salaried professionals alike. It is also anticipated that these reforms would widen the tax base and increase the revenue collected from taxes. Their introduction and efficient implementation would bring extensive benefits to all stakeholders and the general public alike.





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# Policy Report #3

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## US Immigration Reform: Revisiting the Approach to Skilled Visa Provisions

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# Policy Report #3

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# EXECUTIVE SUMMARY

*By Hemant Krishan Singh and Aman Raj Khanna*

On June 26, 2013, The United States Senate passed a far-reaching bill on immigration reform. The “Border Security, Economic Opportunity and Immigration Modernisation Act”, or S.744, was proposed by a bipartisan group of Senators<sup>1</sup> to address deficiencies and resolve problems related to several areas, including the shortage of skilled workers within the US.

In the United States House of Representatives, another very different legislative proposal concerning high skilled immigration, H.R.2131,<sup>2</sup> has been cleared by the House Judiciary Committee. However, the Democrats as the minority party have also introduced an identical version of the Senate passed measure, H.R.15.

In this report, we largely focus on the controversial elements of the bill passed by the Senate. Among the many sweeping changes the bill proposes, several provisions contained in Title IV governing non-immigrant visas such as the H-1B and L-1 programmes have serious and potentially adverse implications, most importantly for US business interests, the US economy and society. At the same time, these provisions threaten the future prospects of the India-US economic relationship.

Among the unquestionably positive elements of the Senate bill with regard to non-immigrant visas is the robust expansion in the annual H-1B visa cap as well as the annual cap on employer sponsored green cards, both of which have been long sought by industry. Recognising the persistent and continuing shortage of skilled STEM<sup>3</sup> workers, the H-1B cap would increase from the current level of 65,000 up to a range of between 115,000 to 180,000, to be determined by annual demand. This move, which will substantially enhance availability of H-1B visas, has been widely welcomed by both US and Indian industry.

The remaining provisions of Title IV, however, reflect a host of unsubstantiated biases, protectionist instincts and personal agendas of lawmakers to nullify some of the gains referred to above.<sup>4</sup> These are largely aimed at

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1 Referred to as the “Gang of Eight”, the sponsors of S.744 included Senators Charles Schumer (D-NY), John McCain (R-AZ), Marco Rubio (R-FL), Richard Durbin (D-IL), Robert Menendez (D-NJ), Lindsey Graham (R-SC), Michael Bennet (D-CO) and Jeff Flake (R-AZ).

2 Sponsored by Congressmen Darrell Issa (R-CA) and Bob Goodlatte (R-VA).

3 STEM refers to Science, Technology, Engineering and Mathematics.

4 The harshest critics of the Indian IT industry in the US Senate include Senators Charles Schumer (D-NY), Richard Durbin (D-IL) and Chuck Grassley (R-IA).



discouraging ‘dependency’ on skilled non-immigrant guest workers with the stated objective of safeguarding American jobs and containing the perceived ‘exploitation’ of the non-immigrant visa programmes. Towards this end, the new provisions place a number of highly restrictive conditions on the employment, deployment and salaries of foreign workers employed under the H-1B and L-1 visa programmes. These include:

1. Hiring restrictions on heavy users of the H-1B and L-1B programmes, progressively limiting all firms to a maximum US workforce composition of 50% of non-immigrant temporary workers within three years of the bill’s entry into force.
2. Additional restrictions on H-1B and L-1B ‘dependent employers’, defined as those whose US-based workforce consists of 15 percent or more H-1B or L-1 employees, including:
  - Ban on outplacement of non-immigrant workers
  - Higher visa fees for additional H-1B and L-1B petitions
  - Strict recruitment conditions for hiring additional non-immigrant workers
  - Annual compliance and reporting requirements
  - New restrictions related to non-displacement of US workers by the sponsoring employer and/or clients for whom visa holders are performing work
3. A higher minimum wage requirement for non-immigrant workers, set at US mean wage for H-1B ‘dependent employers’, regardless of job function.

These constraining provisions of S.744 appear to be misguided, protectionist in nature and discriminatory in impact. The bill’s several workforce-related restrictions aimed at discouraging reliance on temporary foreign workers, particularly targeting hiring practices in the IT services sector, are tightly drawn yet selectively directed in terms of their consequences. Indian IT service providers are placed at a decided disadvantage against their large, diversified US competitors who are better positioned to utilise exemptions included in the bill to escape some of its harshest restrictions. Together, these can make the prospect of hiring H-1B workers far too prohibitive for ‘dependent employers’, in spite of compelling evidence of a domestic skills shortage in the US labour market.<sup>5</sup>

Apart from legislating a non-level playing field, the cumulative impact of these restrictions can be expected to all but smother the operational mobility of the Indian IT services industry, thereby impeding its market competitiveness and ability to serve US businesses. The ban on outplacement for ‘dependent employers’ proposed by S.744 is a particularly egregious instance of loading the bases against Indian IT firms, imposing punitive costs for service providers and their client entities alike.

Furthermore, while the Senate bill makes long-term provisions to promote STEM education domestically through funds accumulated from a range of higher visa fees, there is ambiguity on how firms forced to slash their workforce to comply with the new H-1B limits are expected to replace employees in the short and medium term. In the light of a clear shortfall of adequately skilled workers sourced from within the US, this

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5 At its basic threshold, the bill imposes an additional fee of \$2500 for all H-1B and L-1 petitions and a \$500 fee for every H-1B or L-1 beneficiary a firm wishes to ‘outplace’. There are higher financial burdens for ‘dependent employers’. For those with 15-30% H-1B employees, higher minimum wages are set. Employers who are 30%-50% ‘dependent’ will need to pay the higher minimum wages as well as a visa filing fee raised to \$5000. For high volume employers (50% or higher), visa filing fees are further raised to \$10,000 per petition.

will result in significant disruptions for the Indian IT services industry which presently, by and large, relies on temporary work visas to staff its managerial and technical positions in the US. In turn, the workforce disruptions could have a significant detrimental impact on the operations and productivity of many of the US clients being assisted by Indian IT companies and their employees who are on H-1B or L-1 visas.

In retrospect, protectionist tendencies and populist reactions against “outsourcing” had already been gathering momentum in the US much prior to the financial crisis of 2008. Debate over how non-immigrant visas are being and should be used goes back to the 1990s, but in each past instance policymakers ultimately recognised both the reality of existing skilled labour shortages as well as the intrinsic value of global IT services companies.

More recently, these policy debates were again resurrected in the post-2008 recessionary environment. While unemployment in the tech services sector has steadily declined from a high of 8.3% in September 2009 to just 4% (which is regarded by the BLS as near full employment) in December 2013,<sup>6</sup> the high number of H-1B petitions since 2010 remains controversial. Proponents of the Senate Bill view this as an indicator of excessive H-1B reliance, while the Indian IT industry sees this as indicative of a natural transition to a more efficient global delivery model. The H-1B jobs that would be impacted by S.744 are within the US economy and these contribute to tax and social security revenues.<sup>7</sup>

As a response to changing market conditions, globalisation can lead to the transfer of jobs overseas to economies with a comparative advantage. The Indian IT Industry, however, argues that the H-1B programme in this instance facilitated the offsetting of significant domestic talent shortages, thus allowing businesses to remain local to the US. Far from remedying perceived problems, the new and onerous restrictions on H-1B hires and outplacement could in fact revive offshoring, reversing recent trends in the US economy.

While India’s IT services industry has utilised non-immigrant visas, it has also contributed extensively to investment, job creation and local hiring in the US in the midst of an economic downturn.<sup>8</sup> The political outcomes manifest in the contentious provisions of the Senate bill do not reflect a balanced recognition of this factor.

Ultimately, the proposed legislation threatens a highly rewarding and mutually beneficial engagement between India’s \$100 billion IT services industry and its principal clients in the US market. This industry has been a significant driver of America’s economic recovery, the continuing strength of US corporations in global markets, and India’s own growth story. The restrictions contained in S.744 could erode all of these benefits, deprive US businesses of much needed IT expertise and weaken a pillar of the India-US business partnership. The anti-competitive ramifications of the bill will have adverse repercussions for American businesses and by extension the economy.

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6 Bureau of Labor Statistics (BLS), “Unemployment Rate - Nonagricultural Private Wage and Salary Workers, Professional and Technical Services” web. [http://data.bls.gov/timeseries/LNU04034219?data\\_tool=XGtable](http://data.bls.gov/timeseries/LNU04034219?data_tool=XGtable), Accessed on February 15, 2013.

7 According to the Indian IT industry body NASSCOM, Indian employees of Indian IT firms contribute approximately \$1 billion per annum to social security and over \$3 billion per annum to taxes. Tax contributions have grown rapidly as onshore presence grows, doubling from \$1.6 billion in FY 2006 to \$3.6 billion in FY 2011.

8 The most frequently cited figures by NASSCOM and others indicate that Indian IT firms, directly or indirectly, support 300,000 jobs in the US. Their total investment as of FY 2011 was \$5 billion, and is likely to have grown in light of subsequent acquisitions.

Enactment of a S.744-based immigration bill by the US Congress will trigger adverse reactions in India, holding back progress on bilateral trade and investment issues. It is also unlikely to benefit the climate for the long stalled BIT negotiations which should commence sometime this year.

In our recommendations, we suggest more carefully considered approaches towards skilled non-immigrant visa reform as it advances in the House of Representatives, to focus on market-driven policies and strengthened oversight and enforcement through the expanded Department of Labor (DOL) Review and Investigation Authority. We argue that enough checks and balances have been proposed to ensure compliance and oversight over the expanded H-1B cap. Draconian measures contained in S.744 can hardly be advanced as “reform” of a skilled labour deficit.

Significantly, the House of Representatives version of the bill addressing high skilled immigration (H.R.2131, “SKILLS Visa Act”) avoids the restrictive and discriminatory elements of the Senate bill. This can potentially provide the basis for addressing Indian concerns.

House Speaker John Boehner ruled out voting on the consolidated Senate bill on November 13, 2013, indicating that the House of Representatives may consider and pass a series of smaller bills. Earlier this year, he has also rejected a comprehensive bill like S.744 even for conferencing purposes. However, whether immigration reform fits with the mid-term election year priorities of the Republicans remains to be seen.

The possibility of segmented bills being finessed by an omnibus House bill remains, as legislation related to high skilled immigration is tied directly to the fate of comprehensive immigration reform. Even as the House moves legislation on a piecemeal basis, Congress as a whole and the President can be expected to seek a broader package of immigration reforms. Mid-term election year pressures in 2014 could add to this prospect. It is critically important that H.R.2131 emerges largely intact through the process of any broader deal making.

Since the summer of 2013, it has been increasingly apparent that there is not enough of a constituency in Congress to address repeatedly expressed Indian concerns on the immigration bill, nor has there been any indication of an effort on the part of the Administration to mitigate these concerns.

If anything, the White House has remained silent on these issues, focusing instead on provisions related to green cards, creating new visa pathways for immigrant entrepreneurs and investors, and making key improvements to the H-1B programme, among other such changes. However, it is difficult for the Administration to sustain its stock argument that Indians will benefit from more liberal STEM and green card provisions, when Indian IT services companies will in fact find doors closing on them on account of restrictions and exorbitant costs.

It is well recognised that the US Congress has authority over trade issues, and Congressional decisions tend to be largely driven by domestic factors. The equation between free trade proponents and protectionist constituencies is more often than not tilted towards the latter. Issues of concern to foreign partners of the United States, even those like India who enjoy relative importance in strategic terms, are prone to being bypassed or ignored.

Unfortunately, 2013 also witnessed the steady escalation of India-US contestation over trade and investment issues, including interjections by Congressional Committees and high profile initiatives by Congressional leaders, urging the US Administration to seek remedial measures from India on a host of complaints. The US International Trade Commission was tasked with undertaking an unprecedented enquiry into India's allegedly unfair trade, investment and industrial policies, which is still ongoing.

In raising complaints of economic nationalism on the part of India, US lawmakers need to recognise that support for economic openness is fast waning in the US itself, as the country increasingly turns inward. America's role as a protagonist of an open global economy must start at home with its own policies - in this instance, through upholding a liberal trade regime in IT services. This responsibility for preserving openness rests with the US Congress.

Timely interventions during the continuing Congressional consideration of high-skilled non-immigrant visa reform, taking forward the more balanced provisions of H.R.2131, can better achieve domestic policy objectives for the US, while averting deterioration of its business and investment climate as an open economy. Remedial steps in that direction would be a major step in steering India-US economic relations back on course. Conversely, inaction on India's concerns will disturb a mutually beneficial relationship between US companies and their long-standing Indian IT services partners, which is widely recognised to have driven business expansion, innovation and efficiency.



## INTRODUCTION

In the spring of 2013, a bipartisan group of Senators referred to as the “Gang of Eight” sponsored an ambitious proposal to reform the US immigration system. Eschewing partisanship that had plagued past legislations, Senators Charles Schumer (D-NY), John McCain (R-AZ), Marco Rubio (R-FL), Richard Durbin (D-IL), Robert Menendez (D-NJ), Lindsey Graham (R-SC), Michael Bennet (D-CO) and Jeff Flake (R-AZ) framed a broad-based bill that sought to address a wide range of issues in the US immigration system.

The salient features of their bill included a path to citizenship for the nearly 11 million illegal immigrants in the United States, a more robust enforcement of border security and an overhaul of rules governing non-immigrant, guest-worker visa categories that are intended to supplement the US workforce.

The bill’s provisions on skilled visa reform, contained in Title IV of the measure, have been the subject of much controversy. As a sub-section of the bill, often seen as subordinate to the larger issues of immigrant naturalisation and border security, the scope of the changes proposed in Title IV is both vast and ambitious. Most significantly, the bill includes long-sought measures that increase availability of skilled foreign workers, unequivocally supporting assertions of a domestic skills shortage by the US tech-industry and several lawmakers on both sides of the aisle. This is accomplished through provisions that raise the overall annual quota of H-1B visas and green cards while also creating new categories of visas for entrepreneurs, investors and exceptionally skilled aliens.

However, in addition to these measures, the bill contains provisions that create overall workforce limits while imposing significantly more stringent conditions on hiring of foreign workers through non-immigrant visas such as the H-1B and L-1. These were ostensibly included by the architects of the bill to safeguard American workers against potentially adverse outcomes from an increased inflow of foreign skilled workers, while also addressing existing concerns over the purported capacity for misuse of the current visa programs.

A sizeable segment of US business, led by the IT enabled services (ITeS) industry and their clients, have strongly protested against some of these measures. They have suggested that the restrictions are excessively harsh and even discriminatory as the criterion used by the bill selectively targets them, causing significant

disruptions to business. Indian companies in particular are left at a disadvantage to their competitors in the US market.

These issues are significant, as not only are IT enabled services increasingly integral to the competitiveness of the US economy, but as India's most successful export, they also form the backbone of a highly promising India-US economic relationship.

Upon being introduced before the Senate in April 2013, the "Border Security, Economic Opportunity and Immigration Modernisation Act of 2013", or S.744, was reviewed by the Judiciary Committee before being offered to the floor for debate. On June 27, 2013, the Senate passed an amended S.744 with a majority of 68-32 votes. Only 92 of the 500 amendments to the bill proposed in the Senate received consideration, largely due to filibusters. Most significantly, the bill's most contentious provisions on skilled visas remained intact.

In the United States House of Representatives, another very different version of a bill addressing high-skilled immigration (H.R.2131, "Skills Visa Act"), which avoids the restrictive and discriminatory elements of S.744, has progressed through the Judiciary Committee. However, on October 2, 2013, House members of the Democratic Party introduced a bill, H.R. 15, in the House of Representatives that was closely based on the measure passed by the Senate. The Republican-led House has since been locked in an impasse on the issue over differences in approach to naturalisation and border security.

With mid-term elections due in 2014, it is likely that some form of immigration reform may be passed this year that would include provisions on H-1B and L-1 visas, among many other issues. Even as the public debate has been dominated by the politically contentious naturalisation and border-security aspects of the bill, the provisions on skilled visa reform have far-reaching implications for the US economy. As such, they merit deeper consideration by Congress as it advances its overall immigration agenda in the House of Representatives.

This paper seeks to revisit the bill's provisions on skilled visa reform to better understand their implications and suggests adjustments which merit consideration.

## THE GROWING IMPORTANCE OF STEM IN THE MODERN US ECONOMY

Historically, technological innovation has been a primary driver of US economic growth, by some estimates accounting for half of all growth over the past half-century.<sup>9</sup> Traditionally this innovation had been focused in the manufacturing sector, giving the US significant technological advantages as the world's leading manufacturing powerhouse in a broad variety of goods from textiles to automobiles.

However, with the increasing globalisation of its economy, US primacy in manufacturing has steadily ceded ground to competition from lower cost producers such as China. Even though the manufacturing sector's share of GDP measured by output has remained relatively stable over the past 50 years, this trend has only been made possible by the emergence and spectacular performance of the computer and electronics sub-sector. The concurrent development and proliferation of the internet has also been a game changer for the US economy. A 2011 report by McKinsey and Co. showed that the internet directly contributed to 3.8% of US GDP in 2009 and accounted for as much as 15% of all GDP growth between 2004-2009.<sup>10</sup>

These trends are representative of widely acknowledged shifts in the US economy where its competitiveness in the global context is increasingly led by technology-intensive industries.<sup>11</sup> The simultaneous and dramatic growth of the services sector, particularly finance and healthcare, has only further effected a transition in skill-level demand in the American labour market, to both support these industries and drive further innovation and economic growth. A report by the Brookings Institution suggested that the number of years of

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9 See Abramovitz, Moses. "Resource and Output Trends in the United States Since 1870." National Bureau of Economic Research. 1956. Available at [nber.org/chapters/c5650.pdf](http://nber.org/chapters/c5650.pdf); Solow, Robert. "A Contribution to the Theory of Economic Growth." *The Quarterly Journal of Economics*. 70(1). February 1956. Available at [jstor.org/pss/1884513](http://jstor.org/pss/1884513); Romer, Paul A., "Increasing Returns and Long Run Growth." Rochester Center for Economic Research. Working Paper No. 27. October 1985. Available at [rcer.econ.rochester.edu/RCERPAPERS/rcer\\_27.pdf](http://rcer.econ.rochester.edu/RCERPAPERS/rcer_27.pdf)

10 Matthieu Pélissier du Rausas et al., "Internet matters: The Net's sweeping impact on growth, jobs, and prosperity" McKinsey Global Institute, May 2011. Available at: [http://www.mckinsey.com/insights/high\\_tech\\_telecoms\\_internet/internet\\_matters](http://www.mckinsey.com/insights/high_tech_telecoms_internet/internet_matters)

11 Lauren Dai, "The Comparative Advantage of Nations: How Global Supply Chains Change Our Understanding of Comparative Advantage" *Harvard Political Review*, June 25, 2013. Available at: <http://harvardpolitics.com/features/senior-theses-collection/the-comparative-advantage-of-nations-how-global-supply-chains-change-our-understanding-of-comparative-advantage/>

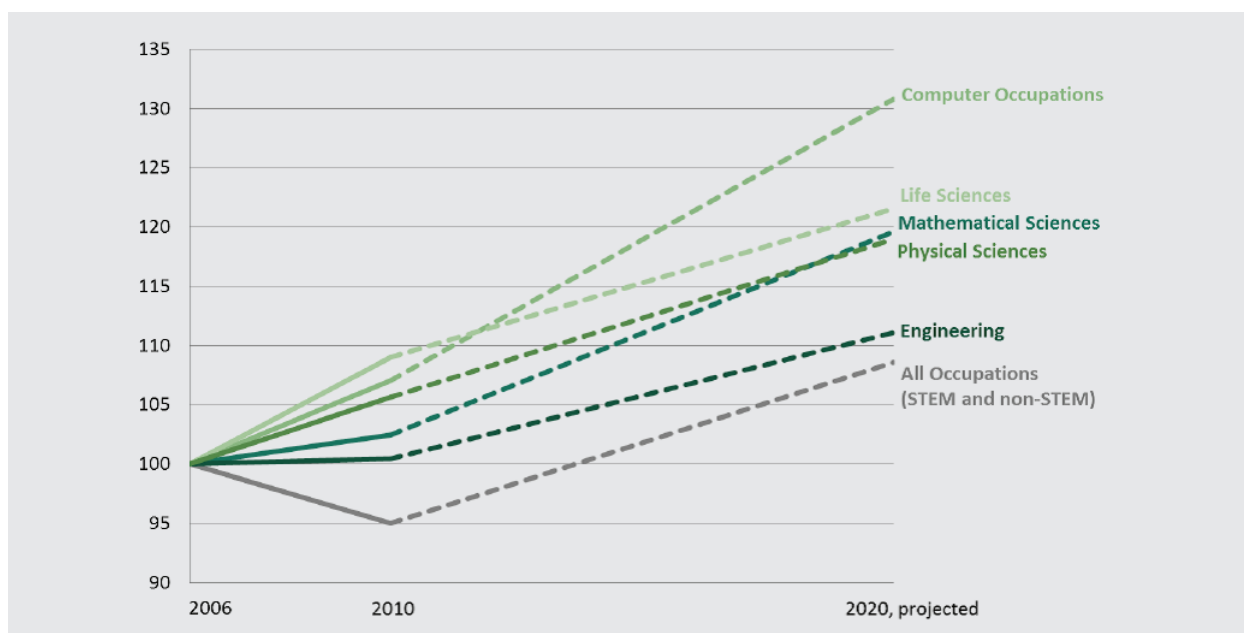


education demanded by the average US job is growing.<sup>12</sup> Degrees in Science, Technology, Engineering and Mathematics (STEM) in particular have come to be highly valued in the US economy.<sup>13</sup>

The preservation of the competitiveness of American industry and exports is contingent upon continuous technological innovation and the adequate supply of these requisite skills to US industry at a globally competitive price. As such, the demand for STEM workers only continues to grow in the US economy.

Figure 1: Sustained Growth Projected for STEM Occupations

(Employment as a percentage of 2006 employment)



Source: U.S. Congress Joint Economic Committee<sup>14</sup>

These factors were instrumental in two significant developments relevant to the context of this discussion:

- i. The establishment of skilled guest-worker visa programs in the US
- ii. The emergence of the IT-enabled services industry

Each of these are discussed below.

## 2.1 Non-Immigrant Skilled Visa Programs in the US

These programmes have allowed firms to import critical skills from abroad in the form of temporary skilled workers when faced with a deficit. Broadly, the two most significant visa categories in this regard are the H-1B and the L-1.

12 Jonathan Rothwell and Alan Berube, “Education, Demand, and Unemployment in Metropolitan America” (Washington: Brookings Institution, 2011).

13 Koebler, Jason, “Demand, Pay for STEM Skills Skyrocket” US News, October 2011 <http://www.usnews.com/news/blogs/stem-education/2011/10/20/stem-competency-a-foundational-skill-jobs-expert-says>

14 “Stem Education: preparing for the Jobs of the Future,” U.S. Congress Joint Economic Committee, 2012, pp2

## H-1B Visa

The H-1B visa was created by the US Congress in 1990 under the Immigration and Nationality Act, to enable US employers to hire temporary foreign workers in specialty occupations, defined as ones that require “*theoretical and practical application of a body of highly specialized knowledge, and attainment of a bachelor’s or higher degree, or its equivalent, as a minimum requirement.*”<sup>15</sup>

This visa has most notably satiated the excess demand for skilled workers in the rapidly expanding STEM fields. By some estimates, over 90% of H-1B applications are for jobs requiring high-level STEM knowledge.<sup>16</sup>

Since its inception, the annual cap on allocation of new H-1B visas has ranged from 65,000 to 190,000, varying more often than not in response to statutory changes rather than market conditions. Certain employers such as universities, non-profit research facilities associated with universities or government research facilities, are exempt from this cap. US Free Trade agreements (FTAs) with Chile and Singapore add an additional 1,400 and 5,400 visas respectively. The unused slots among these are made available to general applicants in addition to the annual cap in the following fiscal year. The annual number of H-1B visas issued consistently exceeds the number of capped visas.<sup>17</sup>

This visa is recognised as a *dual intent* visa, which implies that H-1B holders are permitted to simultaneously seek lawful permanent residence (green card) status in the US while being present in the country on H-1B status. Individuals on visas that do not make this important distinction (such as the B-1/B2 for tourism and business) can be denied admission into the US upon detection of intent to immigrate.

The duration of an H-1B visa is for three years, extendable to six years.

## The L-1 Visa

L-1 visas are available to employees of an international company with offices in both the United States and abroad. The visa allows such foreign workers to relocate to the corporation’s US office after having worked abroad for the company for at least one continuous year within the previous three prior to admission in the US.<sup>18</sup> The US and non-US employers must be related in one of four ways: parent and subsidiary; branch and headquarters; sister companies owned by a mutual parent; or ‘affiliates’ owned by the same or people in approximately the same percentages.<sup>19</sup> The L-1 classification also enables a foreign company which does not yet have an affiliated US office to send an employee to the United States to help establish one, with additional requirements.

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15 “H-1B Visa Defined”, Harvard International Office, 2013, available at: <http://www.hio.harvard.edu/immigration/visatypes/h1b/>

16 Jonathan Rothwell and Neil G. Ruiz, “H-1B Visas and the STEM Shortage” Brookings Institution, May 10, 2013 <http://www.brookings.edu/research/papers/2013/05/10-h1b-visas-stem-rothwell-ruiz>

17 Office of Foreign Labor Certification, “OFCL Performance Data” Web. <http://www.foreignlaborcert.doleta.gov/performance/cfm#stat>. Accessed February 12, 2013

18 US Citizenship and Immigration Services, “L-1B Intracompany Transferee Specialized Knowledge” <http://www.uscis.gov/working-united-states/temporary-workers/l-1b-intracompany-transferee-specialized-knowledge> Accessed February 16, 2013

19 Ibid.

Spouses of L-1 visa holders are allowed to work without restriction in the US (using an L-2 visa), and the L-1 visa, like the H-1B may legally be used as a stepping stone to a green card under the doctrine of dual intent.<sup>20</sup>

## 2.2 The Emergence of the IT-Enabled Services Industry and the Indian Majors

The IT services industry provides services such as software support, computer systems design, and data processing facilities management to clients across a broad range of US industries. With cost-efficiencies achieved through specialisation, economies of scale and leveraging of a global talent pool, these firms allow their clients significant cost advantages with regard to IT functions while also enabling them to focus on their core competencies.

As a result of significant comparative advantages such as a large English-speaking and technically-skilled talent pool, cost-effectiveness of wages, low capital costs and so forth, India has emerged as a leading provider of IT services. Today Indian firms led by Infosys, TCS, Wipro and Tech Mahindra, among others, hold a 55% market share globally.<sup>21</sup>

Though initially focused on business process outsourcing, the spike in demand for IT services prior to the Y2K virus gave these industries a significant foothold towards a growing on-site presence in the US economy. With the concurrent growth proliferation of IT and a growing demand for IT services, these companies have become increasingly integral to the US economy since the early 2000s as their delivery model has evolved.

Like their counterparts in other parts of the world, mainstream providers in the US industry all leverage the global talent pool, relying on a mix of off-shoring and a rotating temporary worker model, to maximize competitiveness of their services.

The firms maintain the majority of their front-office activities within the US, in close proximity to their clients. A significant portion of the staff is in fact 'out-placed', i.e. deployed on-site to the client's premises, to facilitate closer coordination with the client, systems testing and effective feedback to the off-shore development staff.

The profitability of companies depends on technical expertise, innovative services, and effective marketing. As such, these companies rely heavily on STEM-trained professionals particularly with computing services, electronic engineering and information technology skills.

These firms have historically relied heavily on non-immigrant visas to support their workforce needs in the US. Cumulatively, the leading Indian Tech firms have been among the major subscribers to the H-1B visa programme between 2000-2010. Since FY 2011, Indian firms have consistently been the leading users of the H-1B.

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<sup>20</sup> Ibid.

<sup>21</sup> "Why India is Irked by the US Immigration Bill", Knowledge@Wharton, University of Pennsylvania, July 8, 2013  
<http://knowledgetoday.wharton.upenn.edu/2013/07/why-india-is-irked-by-the-u-s-immigration-bill/>

## THE US SKILL DEFICIT

Even as the demand for STEM skills continues to grow rapidly, there are mounting complaints from US companies that the domestic supply is insufficient to meet these demands. Studies suggest that even at the height of the recession, a third of US manufacturers were facing shortages of qualified professionals to staff their technical positions.<sup>22</sup>

These sentiments were reiterated in a letter to President Obama dated March 14, 2013 written by executives of some of the top American technology companies, which affirmed that IBM, Intel, Microsoft and Oracle alone have a combined 10,000 high-skill job openings in the United States that they are struggling to fill.<sup>23</sup> The executives wrote: “One of the biggest economic challenges facing our nation is the need for more qualified, highly-skilled professionals, domestic and foreign, who can create jobs and immediately contribute to and improve our economy.”<sup>24</sup>

Critics of the H-1B programme led by American labour unions have strongly refuted these claims. They argue that each year American institutions produce a number of STEM graduates that not only is the largest in the world, but also exceeds the number of STEM job openings in the economy. They suggest that the primary motivation for high demand exhibited by tech employers is increasing profit margins by hiring foreign workers who are willing to accept relatively lower wages and work longer hours than their American counterparts.

Statistics, however, tell a different story while also confirming that this is a far more complex, multifaceted issue.

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22 Deloitte Consulting LLP, The Manufacturing Institute, and Oracle Corporation. “People and Profitability: A Time for Change.” 2009. Available at: [deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us\\_pip\\_peoplemanagement\\_report\\_100509.pdf](http://deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_pip_peoplemanagement_report_100509.pdf).

23 “Google, Facebook, Microsoft write to Obama for more H-1B visas” *Times of India*, March 19, 2013 [http://articles.timesofindia.indiatimes.com/2013-03-19/job-trends/37843339\\_1\\_high-skilled-immigration-immigrant-visas-h-1b-visas](http://articles.timesofindia.indiatimes.com/2013-03-19/job-trends/37843339_1_high-skilled-immigration-immigrant-visas-h-1b-visas)

24 Ibid.

## Demand from non-STEM employers

Data from US universities suggests that even though there are indeed adequate American born STEM graduates annually to potentially fill the tech-sector's STEM-based openings, for a variety of reasons they do not always wind up in the tech sector. Workforce analyses by industry group and US federal agencies have instead revealed that a high proportion of STEM graduates become employed by non-tech industries. A study by the Georgetown University's Center on Education and the Workforce finds that with increasing technology use across the economy, tech employers face competition for STEM graduates from a spectrum of other industries, including finance and manufacturing.<sup>25</sup> Further, the core STEM-competencies are highly valued in a variety of other, non-STEM job roles. Though the earnings in the STEM sector are among the highest relative to other jobs, graduates can be enticed by even superior earnings in the healthcare or other professional occupations, or sometimes choose alternate careers merely due to a 'better fit' with their interests and value systems.<sup>26</sup> The study found that immediately after graduation, 43% of all graduates with STEM degrees choose not to work in a STEM occupation.<sup>27</sup> After 10 years of employment, a further fifth of these workers choose to leave the field.<sup>28</sup> Though the US does certainly produce the highest number of STEM graduates annually in the world, it is evident that this number is small relative to the size of the population and demand in the US economy.

## Labour Mobility

Bureau of Labor Statistics (BLS) data also indicates a low unemployment rate of between 3-4% for the software and IT services industry, which economists broadly consider as indicative of full employment in this sector. While the 4% rate implies that there are indeed a number of unemployed US citizens in search of work, their employment is more likely constrained by mobility and skill-set limitations.<sup>29</sup> Both the demand and supply of certain skills are never uniform and vary by region, creating localized mismatches between the availability and demand for certain skills by employers in the area. A 2012 study found that only 106 metropolitan areas accounted for 91% of all H-1B visas demanded in the US.<sup>30</sup> Demand was driven heavily by the presence of private STEM-dependent industries or research institutions. There are several factors such as home-ownership or binding ties to present location that prevent a worker laid off in Ohio, for example, from relocating, say to Southern California, to take advantage of job openings.

## Qualitative Deficiencies

An exhaustive report by the Organisation for Economic Cooperation and Development (OECD) points to a more serious trend. In conducting assessments of literacy, math skills and problem-solving using informa-

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25 Carnevale, Smith and Melton "STEM" Georgetown University Center on Education and the Workforce, October 20, 2011 <http://www9.georgetown.edu/grad/gppi/hpi/cew/pdfs/stem-complete.pdf>

26 Ibid.

27 Ibid.

28 Ibid.

29 Wadhwa, Vivek, "It's Not About Skills Shortages", *Harvard Business Review*, June 24 2013 <http://blogs.hbr.org/2013/06/its-not-about-skills-shortages/>

30 Ruiz, Wilson and Choudhury, "The Search for Skills: Demand for H-1B Immigrant Workers in US Metropolitan Areas" Brookings Metropolitan Policy Program, July 2012, <http://www.brookings.edu/~media/research/files/reports/2012/7/18%20h1b%20visas%20labor%20immigration/18%20h1b%20visas%20labor%20immigration.pdf>

tion technology for advanced nations of the world, the report suggests that the skill level of the American labor force is not merely slipping in comparison to that of its peers around the world, but has in fact fallen dangerously behind.<sup>31</sup>

The report attributed the weak performance on failings of the initial schooling system as well as prevailing demographic factors, noting that trends closely followed socio-economic and racial disparities in the US.

If this report's findings are taken into account, it would imply that the problem may be more deep rooted than originally thought and requires a comprehensive review of the US education system and policy. Placing the burden of retraining of the worker population on industries creates further inefficiencies and promotes the loss of competitiveness that the US firms can ill afford at this juncture.

## Aging of Baby Boomers

With increasing numbers of the 'baby boomer' generation reaching retirement age, the American workforce can expect to see dramatically declining workforce participation rates. By 2020, 25% of the US working population will be aged 55 or over. It is estimated that by 2008, the retirement eligibility among this demographic amounted to 13% of the workforce.<sup>32</sup> However, a little less than half of these workers chose to retire, resulting in a 6% reduction in the total workforce.<sup>33</sup> In 2013, the number eligible for retirement is estimated to rise to 20% of the workforce.<sup>34</sup> While exact figures are unavailable, this group will include a significant number of those with STEM skills, thus further reducing the domestic availability of STEM skills.

At present, these trends have collectively manifested themselves as a scarcity of skilled STEM trained workers in the job market. Our earlier observations are corroborated by a May 2013 study conducted by the Brookings Institution, which concluded that vacancies in STEM occupations were harder to fill than other job openings.<sup>35</sup> The study found that nearly 43% of job requisitions for STEM occupations were reposted after a month as compared to only 32% of all postings for non-STEM jobs. The study also found that STEM jobs commanded higher wages as compared to other occupations comparing similar age groups, discounting claims of suppressed and inadequate wages as a major factor in turning away American workers from the sector.

In summary, a wide array of research findings, from research institutions as well as macroeconomic data, together provide compelling evidence of a skill shortage, thus adding credence to the complaints of the tech industry. This issue is compounded by a qualitative decline in the US adult skill level prompted by structural deficiencies in the US education system which will need to be addressed to resolve these problems in the long-term. However, it will take several years to implement solutions and for tangible results to emerge in

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31 OECD, "Time for the US to Reskill?: What the Survey of Adult Skills Says", OECD Skills Studies, OECD Publishing 2013 <http://dx.doi.org/10.1787/9789264204904-en>

32 Tom Donahue. US Chamber of Commerce. "Statement of the US Chamber of Commerce on the Reauthorization of the America COMPETES Act." Testimony before the House Committee on Science and Technology. January 20, 2010. Available at [uschamber.com/sites/default/files/testimony/100119\\_americancompetes.pdf](http://uschamber.com/sites/default/files/testimony/100119_americancompetes.pdf)

33 Ibid.

34 Ibid.

35 Jonathan Rothwell and Neil G. Ruiz, "H-1B Visas and the STEM Shortage" Brookings Institution, May 10, 2013 <http://www.brookings.edu/research/papers/2013/05/10-h1b-visas-stem-rothwell-ruiz>

the US labor market. In the short-term, this will place a heightened emphasis on skilled visa programs and immigration for bridging the STEM deficit faced by employers.

### 3.1 Inadequacies of the Visa Caps

Even as the non-immigrant visas have emerged as increasingly important for US employers to meet their skill requirements, it has become equally apparent that the prevailing visa quotas are inadequate to meet the needs of US employers that were subject to the cap.

In response to frequent over-subscription in the preceding years, the American Competitiveness Act of 2000 temporarily increased the H-1B cap to 195,000 between FY 2000 – FY 2003. However since the expiry of this temporary measure in FY 2004, the cap reverted to 65,000 where it has remained there ever since. Congress did in the same year add a quota of 20,000 additional visas for professionals with advanced (Masters or higher) STEM degrees, bringing the total cap to 85,000.

Since FY 2003, the demand for H-1B visas has far exceeded the annual cap, as is evident from the significant oversubscription of the limited visas available and the rapid rate at which the visa caps have been exhausted (typically months before the fiscal year actually begins).<sup>36</sup>

The USCIS begins accepting applications on the first business day of April, typically either the 1<sup>st</sup> or 2<sup>nd</sup> of the month. As the table below shows, since the annual cap was reset to 65,000 in 2003, the cap has been exhausted within months from the opening date. In 2007, 2008 and then again in 2013, the cap was achieved within mere days.

Table 1: Dates Annual Caps were Achieved 2003-2013

H-1B Visa Immigration Cap Dates, 2013		
Year:	H-1B Cap Numbers	Date H-1B Cap Reached
H-1B 2003 (FY 2004 cap)	85,000	October 1, 2003
H-1B 2004 (FY 2005 cap)	85,000	October 1, 2004
H-1B 2005 (FY 2006 cap)	85,000	August 10, 2005
H-1B 2006 (FY 2007 cap)	85,000	May 26, 2006
H-1B 2007 (FY 2008 cap)	85,000	April 3, 2007
H-1B 2008 (FY 2009 cap)	85,000	April 7, 2008
H-1B 2009 (FY 2010 cap)	85,000	December 21, 2009
H-1B 2010 (FY 2011 cap)	85,000	January 26, 2011
H-1B 2011 (FY 2012 cap)	85,000	November 22, 2011
H-1B 2012 (FY 2013 cap)	85,000	June 11, 2012
H-1B 2013 (FY 2014 cap)	85,000	April 5, 2013

As a result the USCIS has had to initiate a random selection process for the visas (commonly known as the lottery) as the basis to accept petitions. This has serious adverse implications for firms. Firstly, it prevents

36 “H-1B Visa Program: Reforms are Required to Minimize the Risks and Costs of Current Programme” GAO Report to Congressional Committees, January 2011, <http://www.gao.gov/assets/320/314501.pdf>

them from meeting their hiring needs, leaving the fulfillment of these goals to chance. Second, as the GAO noted in a report in 2011<sup>37</sup>, the system has no provision to allow employers to rank their applications so that if a visa is allotted, it is to the best qualified worker that meets their greatest need.

## 3.2 Fall Out: Adverse Impact on the US Economy

In 2007, Microsoft chairman Bill Gates testified on behalf of the H-1B programme on Capitol Hill, warning of dangers to the economy if annual visa and green card allocations were not increased and employers were unable to import and retain skilled workers to fill critical job gaps at tech firms.<sup>38</sup>

Indeed, with over 1.8 million new skilled jobs that BLS reports the US economy will create in the coming decade, the inadequate cap creates a serious bottleneck in access to global labour pools and thus poses a severe threat to the trajectory of US economic growth.

At the same time, the dearth of visas has created substantial inter-industry competition within the US economy. The IT services industry, as the largest consumer of visas in recent years among non-exempt employers, has faced the brunt of criticisms. Lawmakers have taken this a step further, drawing distinctions in the tech industry between IT services providers and ‘true innovators’, alluding to IT manufacturers.

These factors may have provided an impetus to protectionist tendencies, which we will analyze later in this report.

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37 “H-1B Visa Program: Reforms are Required to Minimize the Risks and Costs of Current Programme” GAO Report to Congressional Committees, January 2011.

38 Kronholz, June “Visa Window Opens; Scramble Is About to Begin” Washington Wire, *Wall Street Journal*, March 28, 2007 <http://blogs.wsj.com/washwire/2007/03/28/visa-window-opens-scramble-is-about-to-begin/>



## CONCERNS ABOUT ABUSE OF PROGRAMMES

Concurrent to the growing popularity of H-1B visas, the perception that they are vulnerable to exploitation by employers to the detriment of American workers has remained a significant concern. Reports from as early as the year 2000 by the US Government Accountability Office (GAO) noted major inefficiencies in the enforcement of wage regulations in the programme.<sup>39</sup> While both the economy and industry have seen vast changes since that time, many similar concerns were echoed in the GAO's exhaustive report of January 2011 on uses of the visa programme that could potentially disadvantage the US worker population.<sup>40</sup>

These allegations have been echoed by labor unions and several other quarters who claim that these programmes enable employers to hire foreign workers for cheaper wages even in sectors where adequate domestic workers are available. This allows employers to discriminate against American workers, rather than addressing true skill shortages in the economy.

In reality, US laws bar such blatant wage discrimination. The issue, rather, lies in the employer's ability to misrepresent information so that it results in the computation of a wage lower than that of American workers of a comparable skill level.

The current H-1B visa rules require visa beneficiaries to be paid wages that are equitable with American workers of similar skill within the same geographic area. However, there are two major deficiencies in the system in force, which critics of the programmes say enable employers to circumvent these rules:

- a. **Misuse of Private Wage Surveys** – The law requires employers to pay wages that are “equal to the prevailing market wage or the actual wage”. Even though the Bureau of Labor Statistics (BLS) has an extensive database of occupations adjusted to variations by location, at times there is no practical fit with the BLS wage category and the “actual wage” needs to be computed. The law permits employers to use private

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39 “H-1B Foreign Workers, “Better Controls Needed to Help Employers and Protect Workers” Report to the Ranking Minority Member, Subcommittee on Criminal Justice, Drug Policy, and Human Resources, Committee on Government Reform, House of Representatives. Government Accountability Office, September 2010 <http://www.gao.gov/archive/2000/he00157.pdf>

40 “H-1B Visa Program: Reforms are Required to Minimize the Risks and Costs of Current Programme” GAO Report to Congressional Committees, January 2011.

surveys to determine the actual wages for various job descriptions. Critics allege that an employer may choose to under-represent the actual wage for a prospective H-1B employee, paying them a wage that is less than commensurate with comparable professionals in other firms or geographic areas.

- b. **Exploitation of Geographic Wage Variations** – The US has significant geographic variations in the cost of living as a result of which salaries for the same job can vary widely, particularly between rural areas and major metropolitan areas. Critics of the programme claim that firms wishing to abuse the system can hire a foreign worker in a cheap location such as Akron, but send the worker to an office or client premises in a relatively expensive area such as New York for a substantial discount, despite prohibitions against such practices.
- c. **‘Bodyshopping’** – Staffing firms hire out or ‘outplace’ professionals with specialized skills to clients (purportedly with embellished credentials in many instances), billing them at highly cost-effective wage rates. Critics claim that these firms, however, retain a large portion of the salary as a fee, paying the professional only a reduced portion of the amount paid by the client. Reportedly, they tend to misrepresent skill levels as well as geographic disparities to offer lower wages.

## Worker Immobility

Besides the reported capacity for misrepresentation, critics also point to other characteristics inherent to the H-1B programme that cause a disparity between H-1B workers and their domestic counterparts. Under the current rules, H-1B workers, particularly those awaiting their green cards, may face serious limitations to their mobility within the market, in terms of their ability to change employers. This is partly due to the fact that the stakes are presumably high for H-1B workers, who under the current rules have to leave the country within 60 days upon termination of their employment, unless they can find an alternative sponsor within this time period. Green-card applications on the other hand cannot be transferred from one employer to another without losing one’s place in line as determined by the ‘priority date’. As green card applicants, particularly from countries such as India and China, already face waiting periods of up to ten years for approval of their applications, they have little option but to remain with their employers over that period for fear of jeopardizing their priority date and being sent to the back of the line again. This, according to critics, potentially creates a scenario where, as a former US Secretary of Labor remarked, the H-1B employee “works scared and hard”<sup>41</sup>. Ostensibly, there is significant potential for exploitation by employers, who with the increased bargaining power that they enjoy under the circumstances, may choose to keep wages for such employees low. A study by Sankar Mukhopadhyay and David Oxborrow of the University of Nevada, Reno showed that workers received significant increases in wages averaging \$11,000 following the approval of their Green card, which allowed them to explore opportunities with other employers.<sup>42</sup>

The potential abuse of visas, therefore, has been doubly a matter of concern for US lawmakers. In addition to the violation of laws, it poses a risk to American workers who may be placed at a disadvantage.

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41 North, David, “Motivation for Hiring H-1B workers?” Center for Immigration Studies, August 2013  
<http://cis.org/labor-shortage-not-reason-employers-want-alien-workers>

42 Mukhopadhyay, S. and Oxborrow, D. “Value of an Employment Based Greencard” Department of Economics, University of Nevada Reno, Reno. *Available at:* [http://business.unr.edu/faculty/sankarm/Greencard\\_Revised.pdf](http://business.unr.edu/faculty/sankarm/Greencard_Revised.pdf)

## 4.1 The Role of the IT Services Industry

The reliance of the IT services industry on H-1B workers has brought them under increasing scrutiny, including with regard to purported abuses of the wage law. The GAO's report back in 2000 stated that "workers approved for H-1B visas in IT-related occupations differed somewhat from other H-1B workers in that they were less likely to have an advanced degree, were younger, more likely to be from India, and less likely to be in the United States on another type of visa when approved for the H-1B program."<sup>43</sup>

Even as the Industry's character bears progressively smaller resemblance to that time, the IT services industry remains among the most prolific employers of the H-1B programme.<sup>44</sup> With heightened competition for the limited annual number of H-1B visas available each year, this has increasingly pitted the IT services industry against other tech-based firms in the US.

Critics of the IT services industry's practices, which include several lawmakers instrumental in the framing of this bill, have expressed the view that by consuming a major portion of the limited quota of H-1B visas, the industry both denies availability of visas for 'true innovators' and contributes to an overall underutilisation of the visa programme. At a Congressional hearing on immigration reform by the Senate Judiciary Committee, Sen. Durbin stated: "I think that is an abuse of what we're trying to achieve here. Most people would think, well, Microsoft needs these folks, and they'd be shocked to know that most of the H-1B visas are not going to companies like yours; they're going to these outsourcing companies."<sup>45</sup>

While H-1B filings by the IT services sub-sector may have risen sharply since 2010, the overall unemployment rate in this sector has also steadily declined, from a high of 8.3% in September 2009, to a low of 4% in December 2013,<sup>46</sup> which is regarded by the BLS as an indicator of near full employment. Adding stringent and onerous conditions to the hiring of H-1B workers by the IT services industry carries the risk of a return to outsourcing and offshoring, reversing recent trends which have gone in the direction of onshoring.

Further, critics have noted that even as some of the heaviest users of guest worker visas, the Indian IT services and off-shoring industry sponsors a relatively small fraction of their workers for permanent residency, as seen in Table 2 below. This, they say, gives reason to believe that these firms have little interest in fostering their foreign workers and addressing serious skill shortages. They claim this is an indication that these firms employ the guest worker programs merely as a carousel for hiring expendable temporary labour which is easily replaced at the end of the visa term, thus allowing these firms to keep costs low.<sup>47</sup>

43 "H-1B Foreign Workers, "Better Controls Needed to Help Employers and Protect Workers" Report to the Ranking Minority Member, Subcommittee on Criminal Justice, Drug Policy, and Human Resources, Committee on Government Reform, House of Representatives. Government Accountability Office, September 2010 <http://www.gao.gov/archive/2000/he00157.pdf>

44 According to USCIS statistics the leading Indian IT industry firms have consistently featured among the top 10 employers of H-1Bs over the past decade. In FY 2012, The top 25 Indian firms accounted for over 30% of new H-1B visas as per the NFAP Report: Stuart Anderson, "H-1Bs Essential to Attracting and retaining Talent in America", National Foundation for American Policy, May 2013. Available at: <http://www.nfap.com/pdf/NFAP%20Policy%20Brief%20H-1B%20Visas%20May%202013.pdf>

45 "TCS, Infosys, Wipro abusing H-1B visa system: US Senator" Hindu Business Line, April 23, 2013 <http://www.thehindubusinessline.com/news/international/tcs-infosys-wipro-abusing-h1b-visa-system-us-senator/article4646760.ece>

46 Bureau of Labor Statistics (BLS), "Unemployment Rate - Nonagricultural Private Wage and Salary Workers, Professional and Technical Services" Available at: [http://data.bls.gov/timeseries/LNU04034219?data\\_tool=XGtable](http://data.bls.gov/timeseries/LNU04034219?data_tool=XGtable), Accessed on February 15, 2013

47 Norman Matloff, "Immigration and the tech industry: As a labour shortage remedy, for innovation, or for cost savings?" Migration Letters, Volume: 10, No: 2, pp. 211 - 228, May 2013.

Table 2: H - 1B Visa Immigration Yields for Offshore Outsourcing Firms, 2008

Company	H-1B use rank	Approved H -1Bs	Certified PERMs of H-1B origin	H-1B Immigration yield
Infosys Technologies Limited	1	4,559	237	5%
Wipro Limited	2	2,678	31	1
Satyam Computer Services Limited	3	1,917	10	1
Tata Consultancy Services Limited	4	1,539	0	0
Cognizant Tech Solutions US Corp.	7	467	332	71
Larsen & Tourbro Limited	9	403	11	3
IBM India Private Limited	10	381	0	0
Patni Americas Inc.	13	296	37	13
Terra Infotech Inc.	14	281	7	2
MPhasis Corporation	16	251	81	32

Source: [http://www.computerworld.com/s/article/9128436/List\\_of\\_H\\_1B\\_visa\\_employers\\_for\\_2008](http://www.computerworld.com/s/article/9128436/List_of_H_1B_visa_employers_for_2008) and US Department of Labor, Foreign Labor Certification Data Center.

The economic downturn of 2008 and widespread unemployment that followed brought the fear of job displacement to the forefront of political contention, while aggravating the negative perceptions of the IT services industry. A paper published in 2012 by the Cato Institute noted that “Since the onset of the recession of 2008–2009 and during the jobless recovery of 2010–11, public opinion about immigration further deteriorated. The idea that immigrants take American jobs, depress national wages, and threaten the US economy has become even more rooted, as often happens during economic recessions”.<sup>48</sup>

In a December 10, 2011 episode of his weekly investigative news programme, former CBS news anchor Dan Rather reported the case of a US born worker at a major US corporation being informed of her imminent lay-off and being further coerced into training her lower wage replacements brought in from India under threat of being denied her severance pay.<sup>49</sup> With unemployment in the US economy at its highest in over three decades since the Carter administration, the heightened media scrutiny contributed substantially to increased public concerns and a consequent intensification of the political discourse on the issue.

The IT services industry has staunchly defended itself against these allegations. It has pointed to the US skill shortage as justification for its reliance on workers from abroad, while drawing attention to its efforts to recruit from within the US as well as support for green card reform.<sup>50</sup> It has also objected to reports of widespread misuse of visas, pointing to the tightly drawn visa restrictions as well as the fact that such anecdotal evidence is statistically unsubstantiated. Of 15,648 site visits conducted across a cross-section of employers of H-1B workers in FY 2011, a mere 7% resulted in USCIS notices of minor violations and less than 1 percent resulted in the discovery of serious fraud warranting criminal prosecution.<sup>51</sup> The industry has also emphati-

48 Peri, Giovanni. “Immigration, labor markets, and productivity.” *Cato Journal* 32.1 (2012).

49 Rather, Dan. “Dan Rather Reports – No Thanks for Everything.” Online video clip. *YouTube*. YouTube, 10 December 2011. Web. 9 Sept. 2013.

50 “India’s Tech Industry in the US” NASSCOM, 2012.

51 Tsai, Orr and Lindt, “Mandatory Compliance Issues Employers are Ignoring” Presentation made at American Immigration Lawyers’ Association (AILA) Conference, Nashville, June 2012. <http://www.aila.org/content/default.aspx?docid=39951>

cally showcased the positive impact on the US economy and the competitive edge it provides to US majors in a global marketplace.

Even so, the IT services industry, especially the Indian majors, has largely been fighting a losing battle in terms of public and political perception. Labour unions and several lawmakers have repeatedly blamed its practices for the issues faced by the high skill visa programme, many elements of which have manifested themselves in the legislative proposals leading up to S. 744.

## THE POLICY RESPONSE PROPOSED IN S.744

As discussed in the previous section, the prevailing circumstances created two broad objectives for the architects of the bill. The first of the two was to ensure that the US economy has access to the skilled workers it needs to fill key roles that drive innovation and entrepreneurship, while safeguarding the interests of American workers.

The second addressed concerns that the current system undermined the intent of the guest-worker visa programmes, which included implementing additional safeguards for American workers.

There were broadly four shortcomings that the bill's framers sought to address:

1. Deficiencies in the enforcement of wage rules, including oversight of employers, compliance checks and audits.
2. The qualitative underutilisation of the limited annual quota of H-1B visas: global IT services companies crowding out applications from domestic technology product oriented firms.
3. The requirement to pay market level wages to H-1B workers possibly did not create sufficient incentive for companies to recruit and hire American workers instead.
4. The use of the H-1B programme in outsourcing of American jobs, where temporary foreign workers gain skills during their tenure and take the job back home with them.

Finally, despite the absence of any concrete evidence of technical violations of H-1B provisions, those crafting the bill were particularly mindful of the Indian IT services firms whose practices had garnered unfavorable public opinion.

Several among the consolidated provisions contained within Title IV of the Senate and House Bills were initially introduced in individual legislations by lawmakers.

## Provisions of Title IV of S. 744 and H.R. 15

Title IV of the Border Security, Economic Opportunity, and Immigration Modernisation Act contains an array of reforms to non-immigrant visa programs for both high and low skilled workers, while also creating a new set of visas for investors and low-skilled-non agricultural workers. The provisions in this title are identical in the House and Senate bills.

Title IV of the bill contains the following subtitles:

Subtitle A--Employment-based Nonimmigrant Visas

Subtitle B--H-1B Visa Fraud and Abuse Protections

- Chapter 1--H-1B Employer Application Requirements
- Chapter 2-- Investigation and Disposition of Complaints Against H-1B Employers
- Chapter 3--Other Protections

Subtitle C--L Visa Fraud and Abuse Protections

Subtitle D--Other Nonimmigrant Visas

Subtitle E--JOLT Act (the Jobs Originated through Launching Travel Act of 2013)

Subtitle F--Reforms to the H-2B Visa Program

Subtitle G--W Nonimmigrant Visas

Subtitle H--Investing in New Venture, Entrepreneurial Startups, and Technologies

A full comparison of the changes proposed by the bill to the current law can be found in the annexures to this paper. However, in summary, the salient features of Title IV relevant to the discussion in this paper are outlined below.

Firstly, the bill recognizes the impracticality of the current static quota systems for visas in striking a delicate balance between the two main objectives, specifically in ensuring that foreign temporary workers serve as a means to complement the existing American workforce, rather than as a substitute for it. Towards this end, the bill creates a new system of independent, market-linked dynamic visa quotas for skilled and unskilled workers. The number of visas available will fluctuate between a present maximum and minimum, based on the market demand for workers as expressed in the previous year.

The second segment comprises a series of measures that seek to regulate the use of temporary foreign workers with the dual intent of preventing abuse of the system and safeguarding the jobs of American workers in the same industry.<sup>52</sup> These provisions can be broadly categorized as follows:

1. Additional restrictions on ‘dependent employers’ (defined as those whose workforce consists of 15 percent or more H-1B and L-1 employees) including:<sup>53</sup>
  - a. Prohibition on outplacement of H-1B and L-1 non-immigrant workers so that they cannot perform work for an entity other than the sponsoring employer. In other words, non-immigrant workers sponsored by dependent companies cannot be used to service clients
  - b. Higher visa fees for additional H-1B and L-1 petitions
  - c. Strict recruitment conditions for hiring additional non-immigrant workers
  - d. Strict non-displacement requirements
  - e. Annual compliance and reporting requirements.
2. Hiring restrictions on heavy users of the H-1B and L-1B programs, progressively limiting all firms to a maximum workforce composition of 50% of non-immigrant temporary workers within three years of the bill’s enforcement.<sup>54</sup>
3. A higher minimum wage requirement for H-1B workers, set at a minimum of US mean wage for the industry for H-1B ‘dependent employers.’ Requiring ‘dependent employers’ to pay their visa holders more than their non-dependent competition would and perhaps effectively more than their US citizen workers as well.<sup>55</sup>

The main features of these provisions are broadly described below.

## 5.1 Employment-Based Non-Immigrant Visas: S.744 Provisions

### New Market-Based H-1B Visa Limits

S.744 raises the annual cap on H-1Bs from the current level of 65,000 per annum to a range of between 115,000 and 180,000 annually that will vary by demand.<sup>56</sup> If the base is 180,000 and these visas are used up within 45 days, another 20,000 visas are issued. However the ceiling may not adjust upwards if the unem-

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52 S.744, Sec. 4101 (a) “Border Security, Economic Opportunity, and Immigration Modernization Act (Engrossed in Senate [Passed Senate]” Bill Text - The 13<sup>th</sup> Congress. Library of Congress. Available at: <http://thomas.loc.gov/cgi-bin/query/z?c113:S.744>:

53 A Guide to S.744: Understanding the 2013 Senate Immigration Bill”. Immigration Policy Center – American Immigration Council. July 2013.

54 Ibid.

55 Ibid.

56 S.744, Sec. 4101 (a) “Border Security, Economic Opportunity, and Immigration Modernization Act (Engrossed in Senate [Passed Senate]” Bill Text - The 13<sup>th</sup> Congress. Library of Congress. Available at: <http://thomas.loc.gov/cgi-bin/query/z?c113:S.744>:



ployment rate for the BLS “management, professional and related occupations” category averages 4.5% over the prior year.

S.744 increases the allocation for advanced STEM-degree holders from 20,000 to 25,000 per year.

Together, these provisions increase the availability of temporary foreign skilled workers in order for US tech firms to fill high-skilled positions in R&D etc.

## 5.2 H-1B Fraud and Abuse Protections

### New Definition of H-1B Dependent Employer (DE)

- For employers with 25 or fewer full-time “equivalent employees” who are employed in the US, those which employ more than seven H-1B nonimmigrants;
- For employers with between 26 and 50 full-time “equivalent employees” who are employed in the US, those which employ more than 12 H-1B nonimmigrants; or
- For employers with at least 51 full-time “equivalent employees” who are employed in the US firms where H-1B workers are at least 15 per cent of the full-time workforce.
- Exempt from H-1B-dependent employer classification:
  - Nonprofit institutions of higher education;
  - Nonprofit research organisations; and
  - Healthcare businesses in certain cases

### New H-1B Skilled- Worker Dependent Employer (SWDE)

The bill creates a new concept of a *H-1B skilled worker dependent employer*, defined as employers where at least 15 percent of workforce in O\*NET Job Zone 4 (“considerable preparation” needed) and Zone 5 (“extensive preparation” needed) positions are H-1B workers.<sup>57</sup>

The new rule focuses on the number of H-1Bs relative to the skilled sub-population of a firm’s workforce. Thus firms that do not classify as dependent employers, may still find themselves classified as a SWDE if H-1Bs constitute a high proportion of the skilled component of their workforce. (See example in Annexure 1 of this report).

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<sup>57</sup> The Occupational Information Network (O\*NET) is a free online database developed under the sponsorship of the US Department of Labor/Employment and Training Administration (USDOL/ETA) through a grant to the North Carolina Employment Security Commission during the 1990s that contains occupational definitions to help students, job seekers, businesses and workforce development professionals to understand today’s world of work in the United States.

## A higher minimum wage requirement for H-1B workers

The bill will introduce a new wage system that groups US wages into three tiers as opposed to the older four-tier system. It also establishes a wage-floor for H-1B ‘dependent employers’ that requires them to pay wages to all H-1B employees at a minimum of the second level, which is the equivalent of the average of all US wages for the worker’s job category as surveyed by the US Department of Labor.

## Non-displacement of US workers

H-1B dependent employers will be expected to demonstrate that no US-born worker was displaced 180 days before and after the filing of a petition for an H-1B worker.

H-1B skilled dependent employers must certify that they did not displace a US worker in the 90 days prior and after the filing of an H-1B petition.

## Recruitment Restrictions

Prior to filing a petition, H-1B skilled dependent employers have to attest that they offered the job to an equally or better qualified US worker.

Other firms will need to ensure this will include the posting of the job to a Department of Labor job-search portal for a minimum specified period.<sup>58</sup>

## Hiring restrictions on heavy users of the H-1B and L-1 programmes

Also referred to as the ‘50/50’ law, the provision proposes a maximum limit of 75% on the percentage of a company’s workforce that may be composed of H-1B and L-1 visa holders along with a schedule to progressively reduce this to 50% by the third year of the law’s implementation. In 2015, this limit will be set at 75% of the total workforce, reduced to 65% in 2016 and to 50% from 2017 onward.

## Prohibition on outplacement of non-immigrant workers to client sites

This provision, widely regarded as the most targeted and punitive of the bill’s measures, prohibits any company categorized as “dependent” from “placing, outsourcing, leasing, or otherwise contracting for the services or placement” of an H-1B or L-1 worker with another employer.<sup>59</sup> Non-dependent employers also have to pay a \$500 fee for each outsourced non-immigrant employee.<sup>60</sup> Non-profits and healthcare providers, however, are exempt from the prohibition on outplacement if they are found to be dependent, but will be expected to pay the \$500 per employee fee.<sup>61</sup>

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58 S.744, “Border Security, Economic Opportunity, and Immigration Modernization Act (Engrossed in Senate [Passed Senate]” Bill Text - The 13<sup>th</sup> Congress. Library of Congress. Available at: <http://thomas.loc.gov/cgi-bin/query/z?c113:S.744>

59 Ibid.

60 A Guide to S.744: Understanding the 2013 Senate Immigration Bill”. Immigration Policy Center – American Immigration Council. July 2013.

61 Ibid.

## Higher visa fees for ‘dependent employers

The bill will impose substantially higher H-1B and L-1 visa petition fees on employers that already rely heavily on non-immigrant workers. Firms employing between 30 percent and 50 percent of their workforce cumulatively on non-immigrant visas will be charged a filing fee of \$5,000 for each additional H-1B or L-1 visa petition. Additionally, in the interim period leading up to 2017, all firms in excess of the 50 percent threshold will pay a visa fee of \$10,000 per additional visa application.

## Other restrictions

‘Dependent employers’ will be required to meet additional restrictions in the process of hiring foreign workers through non-immigrant visas including:

They will be expected to demonstrate that no US-born worker was displaced 180 days before and after, as the direct result of the hiring of a foreign worker.<sup>62</sup>

They will have to submit to annual Department of Labor compliance audits.<sup>63</sup>

They will need to advertize a toll-free Department of Labor hotline to their employees for reporting any infraction of the new laws.<sup>64</sup>

## INVEST Visas

The bill proposes the creation of an additional set of visas with the aim of fostering investment and job-creation in the United States. These include:

X Visa – This non-immigrant visa will allow entrepreneurs temporary residency of up to three years in the US, provided that prior to the application, their businesses would have had to attract at least \$100,000 in investment, or have created no fewer than three jobs, while generating \$250,000 in annual revenue over a two year period.

EB-6 immigrant investor visa – This leads to Lawful Permanent Residence for entrepreneurs who have significant ownership in a US business that must have received either \$500,000 in investment or created five jobs while generating \$750,000 in annual revenue in the previous two years.

## Y Visa

This will create a visa for non-immigrant alien retirees over the age of 55 who possess health insurance and invest (and maintain) at least \$500,000 in US residential real estate, of which at least \$250,000 must be for a US primary residence where such persons intend to reside for more than 180 days per year.

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62 Ibid.

63 Ibid.

64 Ibid.

## Relevant Measures for Employment-based Immigration from Title II

In addition to the measures put forward within Title IV, the bill makes relevant proposals in Title II that have implications for non-immigrants. These include:

Country-specific limits on employment-based immigrant visas will be eliminated and massive backlogs, particularly for applicants from India and China, will be cleared over seven years beginning in 2015.

Highly skilled or exceptionally talented immigrants, including multinational executives, those with an advanced degree in the STEM fields from a US university and physicians in underserved medical fields will be exempt from the annual world-wide cap.

### 5.3 A Broad Analysis of the Provisions

The bill's proposals will prove to be a bonanza at the individual level for skilled workers of foreign origin, particularly graduates of US educational institutions and those belonging to the STEM fields. It takes progressive short-term measures to address the critical deficiencies of the US Labour market. Most visible among these is the substantial expansion of the H-1B cap in order to increase the availability of skilled workers to employers. Exemptions for highly qualified professionals and physicians address innovation and workforce limitations for STEM industries as well as the healthcare system. The abolishing of backlogs in the Green Card waiting lists and important steps to facilitate portability among employers for workers awaiting permanent residency status without adverse repercussions to their priority status are other welcome changes.

At the same time, the bill proposes a series of measures that address past concerns on enforcement of visa rules by expanding the authority and capabilities of agencies under the Department of Labor and the DHS to conduct audits and compliance checks. Measures include greater compliance requirements for 'dependent' firms, along with stiffer fines and consequences for violations, not to mention additional restrictions on hiring in the form of the 'non-displacement' restrictions.

In the long term, the bill proposes important initiatives to promote STEM education among US students which will be critical to US self-sustainability and economic success.

The caveat lies in the fact that even as it increases the overall pool of guest-workers, the bill also substantially raises the hurdles for firms to access these workers. This begins with intensifying several onerous prerequisites in the recruitment process that must be fulfilled in order for a firm to hire workers on the H-1B. This is followed by a new wage system that increases the minimum wages that H-1B workers must be paid at all levels. While these provisions may adversely impact the employability of virtually all H-1Bs, it will be particularly severe for those who would normally qualify for a remuneration package at the bottom of any one of three new wage bands.

The consequences of the 'dependent employer' and new Skilled-worker dependent employer will be critical for firms to consider as most of the bill's most severe impacts are linked to these classifications.

These are explored in further detail in the following chapter.

## IMPACT ON EMPLOYERS

The *H-1B dependent employer* (DE) and new *H-1B skilled worker dependent employer* (SWDE) classifications that can be expected to prove the most crucial litmus test for employers in the US hoping to engage H-1B workers.

While the first of the two classifications (DE) is not new, the magnitude of the new restrictions contingent upon it under the proposed provisions of S.744 confers unprecedented significance to this threshold for employers. In the meanwhile, the new SWDE classification lends itself to broadening the purview of these restrictions to include firms that may have otherwise avoided them under the criteria for a DE.

These restrictions are summarized in the table below (Table 3). (For a detailed explanation of the evolution of these classifications and a comparison refer to Annexes 1 and 2 of the paper).

In addition to the direct financial burden of higher wages and visa fees, the intensive audit and compliance requirements will translate into significant indirect costs for firms falling under either of these classifications. Describing these requirements as an “administrative nightmare”, analysts expect impacted firms to have to devote substantially greater investments into administrative and legal resources to both prepare and comply with these requirements.<sup>65</sup>

Consequently, the bill transforms what has so far been an innocuous and primarily administrative benchmark into a critical threshold at which the bill’s most adverse ramifications for businesses that employ skilled non-immigrants are triggered. Therefore, the DE and SWDE classifications are central to our analysis of the bill’s deficiencies.

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65 “Visa Reform: Much ado about nothing, or a nuclear threat to the Indian sourcing model?” Recorded Webinar hosted by HfS Research and Wells Fargo Securities. June, 2013. Available at: <https://www3.gotomeeting.com/register/605013382>

Table 3: Additional Hardships for DEs and SWDEs

No.	Category	Non-DE or SWDE Employers	Additional Restrictions for DE or SWDE
1	Higher Wages	Firms must pay the greater of the <u>actual wage</u> paid to similar employees or the <u>prevailing wage</u>	DEs must pay at least ‘Level-2’ wages that are equal to the mean of all surveyed wages, raising the overall cost of employing H-1B workers
2	Non-displacement Restrictions	No non-displacement time restrictions unless they are displacing a public school teacher, a US worker at a federal, state or local govt. entity or filing the H-1B petition with intent to displace a specific US worker	DEs and SWDEs must demonstrate that no workers were displaced before and after the filing of H-1B applications
3	Recruitment Restrictions	Employers must use industry-wide recruitment standards	SWDEs compelled to offer the job to a US worker that is equally or better qualified
4	Outplacement Restrictions	Firms must pay a fee of \$500 for every worker that will be placed at a third-party site.	DEs prohibited from outplacing workers to client sites unless they are non-profit institutions of higher education, research organisations or healthcare business
5	Higher Filing Fees	Filing fees raised to \$1,250 for firms with 25 or fewer full-time employees and \$2,500 for firms with greater than 25 employees	Firms pay a higher fee of \$5,000 per application if portion of employees on H-1B and L-1 visas exceed 30% of the workforce
6	Mandatory Audits	DOL may conduct voluntary surveys of all employers	All DEs with greater than 100 employees will undergo a mandatory annual audit by the DOL

## 6.1 Evolution of the DE and SWDE Classifications

A compromise deal between Senators Schumer (D-NY) and Hatch (R-UT) in May, 2013 to gain the latter’s support during the Senate Judiciary Committee’s markup process was a crucial milestone in the evolution of these benchmarks as they stand today.<sup>66</sup>

As an advocate of the technology industry, Sen. Hatch had held strong reservations against the industry-wide non-displacement and recruitment conditions proposed by the original draft of the bill. He echoed the opinion that these made the H-1B programme unworkable even as other provisions raised the annual ceiling to increase the availability of visas.<sup>67</sup> Industry representatives had feared that these provisions permitted far too much interference by the Labor Department in hiring decisions rather than relying on the employer’s best judgment.

Amendments resulting from the deal (Hatch 10-17)<sup>68</sup> made several important changes to Title IV.<sup>69</sup> Two aspects particularly relevant to our current focus are:

66 Alexander Bolton and Jennifer Martinez, “Schumer and Hatch Strike Breakthrough Deal on H-1B Visas”, The Hill, May 21, 2013. Available at: <http://thehill.com/homenews/senate/300989-schumer-and-hatch-strike-breakthrough-deal-on-h-1b-visas>

67 Orrin G. Hatch, “Statement Before the Senate Committee on the Judiciary Executive Business Meeting”, May 21, 2013. Available at: [http://www.hatch.senate.gov/public/\\_cache/files/0c02a230-fd10-4d64-b051-b530fe66e6eb/Statement%20for%20immigration%20markup%205-21-13.pdf](http://www.hatch.senate.gov/public/_cache/files/0c02a230-fd10-4d64-b051-b530fe66e6eb/Statement%20for%20immigration%20markup%205-21-13.pdf)

68 See: United States Senate Committee on the Judiciary, “S.744 Amendments”, Hatch 10 – 17. Available at: <http://www.judiciary.senate.gov/legislation/immigration/amendments.cfm>

69 For a summary of all changes made under these amendments, see: Federation for American Immigration Reform, “FAIR Summary of S. 744: Title IV—Reforms to Nonimmigrant Visa Programs; High Skilled Workers”, May 29, 2013. Available at: [http://www.fairus.org/DocServer/amnesty\\_2013\\_debate/FAIR\\_Summary\\_of\\_Gang-of-8\\_Nonimmigrant-Visa\\_Provisions\\_TitleIV\\_H-1B\\_6-6-13.pdf](http://www.fairus.org/DocServer/amnesty_2013_debate/FAIR_Summary_of_Gang-of-8_Nonimmigrant-Visa_Provisions_TitleIV_H-1B_6-6-13.pdf)

1. The creation of the *skilled-worker dependent employer* category
2. A group of amendments to the non-displacement and recruitment restrictions previously intended to apply to all US employers so that they now applied only to employers who qualified as DE or SWDE

Although the deal did not entirely eliminate the non-displacement and recruitment conditions as part of the concessions for the tech industry, Sen. Hatch did succeed in raising the threshold for these restrictions to apply to DE employers.

However, the amendments also included the creation of the SWDE category, ostensibly to prevent dependent employers from diluting the ratio of H-1B workers in their workforce by hiring relatively low-skilled employees.

Together, these changes are especially relevant as together they tightened the visa dependency criterion, while adding additional gravity to the DE threshold.

## 6.2 Workforce Restructuring

Employers will devote serious efforts towards avoiding classification as either DE or SWDE in view of the adverse impacts on business costs and operations that ensue. This is a far greater imperative for firms which rely on the outplacement practice significantly in their business model. Falling under the ambit of the ban would require them to withdraw their workers from client locations in order to comply with the law, causing serious disruptions to ongoing projects and jeopardizing client relations and future business.

For affected employers, all available options pertain to some form of workforce restructuring. This can be broadly divided into two groups of measures. The first pertains to hiring of additional US workers, possibly in combination with phasing out of some non-essential H-1B workers. The second pertains to other secondary strategies such as availing exemptions permitted under the language of the bill, retraining US workers or enlarging the US component of the workforce through acquisitions. Both these possible courses of action are discussed below.

### Primary Course of Action - Enlarging the Proportion of US Workers

For a firm faced with the possibility of being categorized as a DE or SWDE, recruitment of additional US workers would be the first and most attractive option with marginal variation depending on whether the firm classifies fundamentally as DE or SWDE. Firms that are SWDE, but do not qualify as DE, will focus on hiring skilled US workers that qualify under O\*Net Job Zones 4 and 5. Firms that are DEs are highly likely to focus on both skilled and unskilled workers. However, due to a finite supply of US workers possessing appropriate skills and higher wage expectations in a tight market, the scope of this option as a solution is limited, especially for firms which require intensive restructuring to comply with the new requirements proposed by the bill and/or are faced with a relatively tighter labor market for skills specific to their industry.

## Secondary Course of Action - Pursuit of Alternative Strategies

Firms that are unable to cover their requirements will consider a second course of action, which broadly entails any combination of:

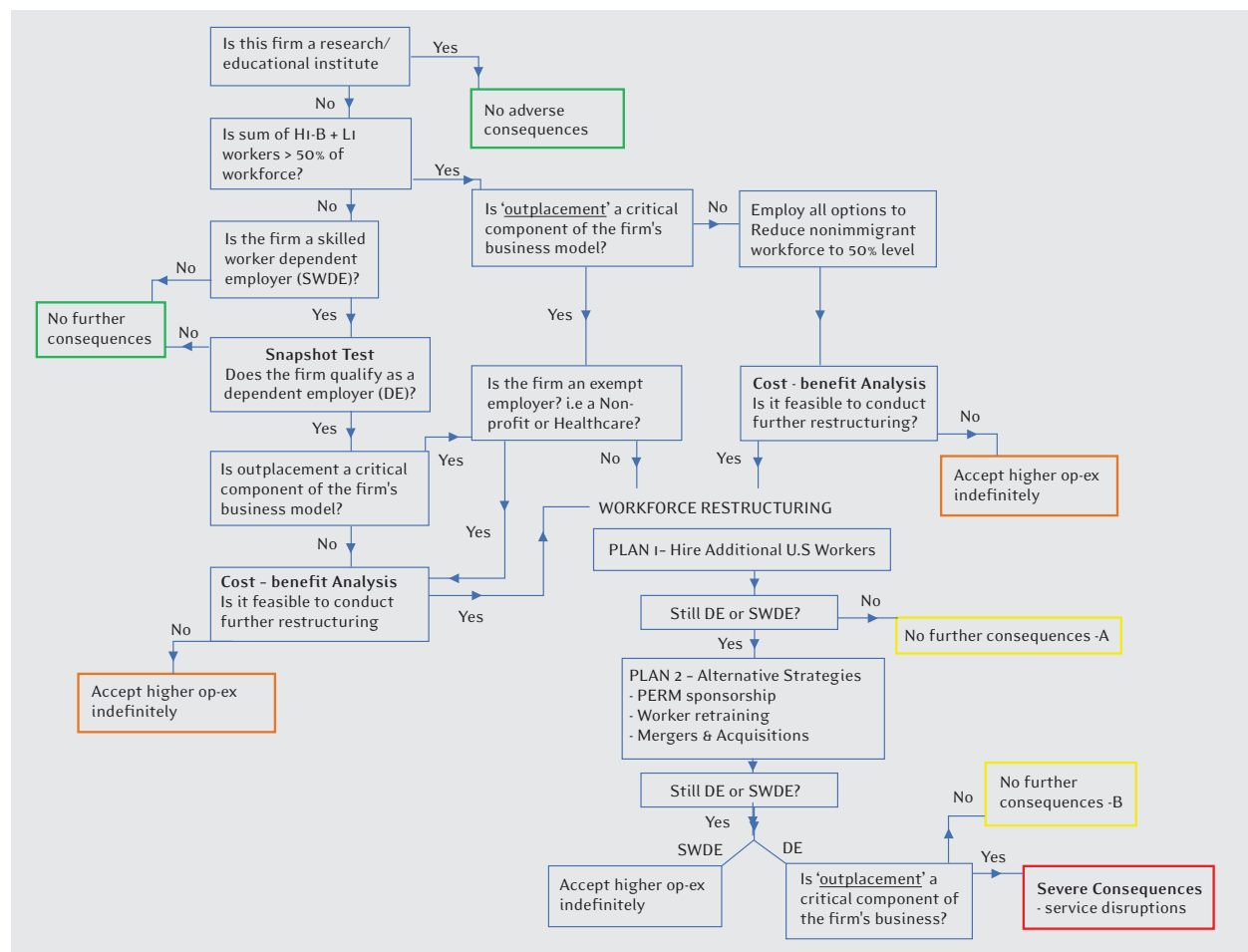
1. Intensive PERM sponsorship to avail the *covered employer* exemption
2. Implementation of retraining programs for US workers to meet their skill requirements
3. Strategic Mergers and Acquisitions of/with firms possessing large US workforces

For firms which do embark on this route, the preference among the three options would vary from case to case, based on firm-specific requirements. However, each of these options require substantial capital investments.

This will oblige individual firms to conduct an intensive cost-benefit analysis to determine whether embarking on this second course of action is even feasible in the short term, compared to the alternative of simply accepting the higher costs of business associated with the DE and SWDE classifications.

To better understand how various factors will impact firms and establish the outcomes, we have created a representative model (Figure 2).

Figure 2: How Businesses are impacted by the Provisions of S.744





The provisions consequently effect four distinct outcomes on employers of the H-1B programme:

1	No Consequences		
2	One-Time Capital Expenditure	Tier-1	Plan 1 Costs
		Tier-2	Plan 1 + Plan 2 Costs
3	Higher Op - Ex, Indefinite Time-frame	Tier-1	Accepted Higher Opex, No or Minimal Restructuring Costs
		Tier-2	Higher Opex Despite Restructuring Costs
4	Severe Consequences	Business disrupted, Revenue impacted severely	

The ultimate course of action and resulting outcomes will be determined by four broad considerations:

**1. Existing workforce composition relative to the *dependent employer* threshold**

This will determine the scope and intensity of restructuring required. Firms closer to the 15% margin will find it far easier to cope.

**2. Market availability of suitable US workers**

This will determine the ease and cost of hiring US workers that meet the requirements of a firm's business to supplement or replace its H-1B workforce.

**3. Relevance of 'outplacement' to the firm's business model**

Firms which rely on outplacement face far graver consequences of qualifying as DEs as a result of the ban on outplacement and have little option but to restructure. In contrast, firms which do not rely on outplacement may find it more feasible to accept higher costs and restrictions of the DE classification in the short term.

**4. Capacity to pursue alternative strategies (including training, green card sponsorship costs, merger and acquisitions)**

The specific implications of these disparate outcomes, as well as the merits of the factors, are discussed in greater depth below.

## 6.3 Analyzing the Adverse Implications

There are likely to be several pitfalls and drawbacks that will create an unequal footing for employers in the US economy.

### 1. Bias against firms employing the outplacement practice

Outplacement practice is a key determinant for the severity of adverse outcomes for firms under the new rules proposed by S.744. Among firms that are unable to avoid the dependent classification with workforce restructuring, the impending ban on outplacement results in far graver consequences for firms that rely on this practice (such as disruption of business as well as loss of clients and revenue) as opposed to other firms which can expect higher operating costs and administrative burdens.

As the ban comes into force with immediate effect, firms that depend on outplacement do not have the luxury of accepting any alternative except a drastic reduction in their H-1B workforce down to 15% to ensure business continuity.

Ostensibly, the bill's architects have made the assumption that all firms that outplace workers but also have a high percentage of H-1B or L-1 workers are invariably abusing the H-1B visa programme by providing 'labor for hire' at lower wages. While this most visibly impacts the ITeS industry at the moment, with a worsening of the STEM deficit, additional industries who use the outplacement practice may also find themselves fall under the purview of this ban as they ramp up hiring of H-1Bs to supplement their workforces.

Further, the bill already includes several steps to eliminate the potential for fraud and abuse. These include more stringent wage laws that will make H-1Bs more expensive on average, additional non-displacement rules as well as safeguards against visa abuse and fraud that are intensified for 'dependent employers.' These are supplemented by the facilitation of greater oversight, tougher compliance requirements and the like. Collectively, these provisions are tightly drawn and make the hiring of H-1B workers not only tougher but also substantially more expensive (even discounting the higher visa fees), particularly for 'dependent employers.'

In the light of this series of measures that more than adequately dissuade frivolous hiring of H-1Bs in a manner that would potentially threaten the interest of the American workforce, the inclusion of the ban on outplacement is highly questionable.

## 2. The varying availability of specific skills

The market availability of US workers can vary significantly between specific skills and also by geography.

The availability of skill classifications within the broad STEM umbrella can vary greatly. In view of the prevailing unemployment rates, for instance, an offshore drilling firm setting up a new facility in early 2013 would have had a far easier time employing US – born ship engineers (with an unemployment rate of 15.8%) than say petroleum engineers who at an especially low unemployment rate of 0.6% were already in extremely short supply in the domestic labour market.<sup>70</sup>

This experience is magnified for businesses that require niche skills or 'hot skills' that see a sudden surge in demand when the industry experiences rapid success. For example, the success of the iPhone saw a surging demand for application developers familiar with Apple's proprietary operating system. The ability to import labour is critical in such situations so as not to deflate the industry's nascent success.

Further, the supply of specific skills is anything but uniform across the US and can vary significantly by region based on several factors such as demographics, quality of primary and high-school education, prevalence of universities etc. While availability of skills is an important consideration for businesses in choosing a location, they are also motivated by several other factors such as capital costs, tax rates, local wages, availability of raw material and the like. As a result, local mismatches can frequently occur between demand

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70 "2012 Jobs Snapshot: Unemployment Rates by Occupation" Wall Street Journal, January 8, 2013. Available at: <http://online.wsj.com/news/articles/SB10001424127887323936804578229873392511426?mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2F%2FSB10001424127887323936804578229873392511426.html>

and availability, which can be magnified when very specific skill sets are taken into consideration. These are further compounded by immobility resulting from the labor's inability or unwillingness to relocate. This is a particularly important factor in the US where the high rates of home ownership add binding ties that make it tougher for workers to relocate.

For example, as a result of the shale gas boom on the US Gulf Coast, Texas is expected to experience the second highest growth rate in the country for STEM jobs. However, the state also graduates a relatively lower number of students in STEM degrees.<sup>71</sup>

In a report from June, 2013, Fluor Corp, an engineering and construction conglomerate, was already experiencing serious challenges in finding appropriately skilled labour for its energy infrastructure construction projects in Texas.<sup>72</sup> The report stated that the firm faced a pinch particularly in the supply of craft labor, such as welders, electricians and riggers which otherwise experienced some of the highest unemployment rates nationwide at 11.3% during the same period, according to statistics from BLS.<sup>73</sup> The firm's CEO added that they had experienced problems in getting workers to relocate on-site from as little as one state away.<sup>74</sup>

In the light of an overall skill deficit, at times amplified by industry-specific requirements and localized deficiencies, the DE and SWDE classifications will create serious constraints to the ability of firms to hire the skilled-workers they need.

### 3. Giving conglomerates an edge over specialized firms

In the calculation for dependent and skilled-worker dependent employers, the bill relies on Section 414 of the Internal Revenue Service Code to determine a firm's total workforce in the US.<sup>75</sup> On this basis firms may count the workforces from other industry segments towards the calculation of their total workforce. This has adverse implications in this case as it allows diversified firms to count their American workers from unrelated, lower-skilled industries (which may not have such severe domestic workforce shortage issues) to leverage the workforce calculations for their more H-1B dependent practices.

Consider the example of two near identical firms A and B that provide expert geological analysis to the oil and natural gas industry. Outplacement to off-shore oil rigs is a key component of their business model. Both have a total workforce of 100, and 19 H-1Bs staffing some of their senior positions. Once the rules of S.744 are enforced, both can be ostensibly classified as Dependent Employers, thus disrupting the ability of

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71 Courtni Kopeitz, Natalie Wall and Julia Taylor, "Supply and Demand Mismatch leaves STEM jobs unfilled", STEMwire, October 3, 2012. Available at: <http://stemwire.org/2012/10/03/supply-demand-mismatch-leaves-stem-jobs-unfilled/>

72 Ben Kesling, "Fluor challenged by shortage of skilled labor amid US shale boom" *Hydrocarbon Processing*, June 25, 2013. <http://www.hydrocarbonprocessing.com/Article/3223288/Fluor-challenged-by-shortage-of-skilled-labor-amid-US-shale-boom.html>

73 Bureau of Labor Statistics, "Labor Force Statistics from the Current Population Survey; Unemployed persons by industry, class of worker, and sex". Available at: <http://www.bls.gov/cps/cpsaat26.htm>. Accessed on March 7, 2014

74 Ben Kesling, "Fluor challenged by shortage of skilled labor amid US shale boom" *Hydrocarbon Processing*, June 25, 2013. <http://www.hydrocarbonprocessing.com/Article/3223288/Fluor-challenged-by-shortage-of-skilled-labor-amid-US-shale-boom.html>

75 See: Cornell University Law School, "26 U.S. Code § 414 - Definitions and special rules; Title 26 › Subtitle A › Chapter 1 › Subchapter D › Part I › Subpart B › § 414". Available at: <http://www.law.cornell.edu/uscode/text/26/414>

some of their key H-1B staff to enter their clients' premises, besides hampering their ability to hire any additional H-1Bs should suitable US workers be unavailable.

However, firm B has a sister concern B2 that provides logistical support to offshore drilling rigs. B2 has 100 employees and 10 H-1Bs. As such, firm B's dependency will be calculated on the basis of the total H-1Bs and workforce of firms B+ B2.

Therefore, with 29 H-1Bs for a total workforce of 200, B and B2 both escape qualification under the Dependent Employer category.

However, while firm A is unable to send its key employees to clients and faces annual audits and so forth, Firm B, with an identical workplace breakout, escapes the additional restrictions.

While this does not guarantee an advantage in evading the SWDE classification which pertains specifically to skilled workers, it will almost certainly benefit a firm toward avoiding the serious restrictions of the DE classification.

More importantly, it allows external, and unrelated factors to influence a market.

#### 4. Disadvantaging firms with low capital availability

In a tight market for STEM skills, the pursuit of any of the three broad strategies (namely sponsoring additional PERM applications, retraining US workers or mergers and acquisitions) to reduce reliance on H-1B workers requires significant capital investments. Capital availability will be a key metric in determining a DE or SWDE's strategy and ability to reduce its workforce to acceptable levels. Therefore firms that are not profitable enough to undertake these costs are put at a distinct disadvantage as those that are more easily able to absorb these against their bottom line.

## Other Concerns:

### I. Adverse Impact of the SWDE classification on Small firms

Legislators recognized that the large majority of H-1B workers were of a higher skill level than under the O\*Net descriptors, would fall under Job Zones 4 and 5, defined as ones requiring "considerable preparation" or "extensive preparation" respectively. As the DE definition relies on the number of H-1Bs as relative to the total workforce, lawmakers ostensibly feared that firms with large numbers of US workers in non-skilled positions could potentially continue to rely unduly on H-1Bs to staff skilled positions while evading the DE classification altogether. By further increasing scrutiny by a level to a firm's skilled-worker pool, the SWDE classification is intended to thwart such potential discrimination and ensure an additional level of protection for skilled American workers.

Broadly, the consequences associated with a SWDE are marginally lower than those that apply to a DE, in particular with regard to minimum wage norms and possibly outplacement.<sup>76</sup> However, the SWDE classification creates several more hurdles and carries the potential for adverse impact.

Foremost among these include the tremendous burden it places on all firms for calculating their dependency. The firms’ human resource and legal departments would have to classify each and every employee according to O\*Net standards, separate the skilled workers who qualify under Jobs Zones 4 and 5, and then calculate skilled worker dependency.

Unlike the DE classification, which applies a graded standard with separate criteria for firms up to 25 employees, those with between 25 and 50 employees and ones with 51 or more employees, the SWDE allows for 15% H-1B employees regardless of number.

Table 4: Comparison of Restrictions for DE and SWDEs

Firm Size <i>By no. of full-time equivalent employees (FTEs)</i>	Dependent Employer (DE)		Skilled - Worker Dependent Employer (SWDE)	
	<i>Rule for qualification as per S.744</i>	<i>Max H-IBs allowed</i>	<i>Rule for qualification as per S.744</i>	<i>Max H-IBs allowed</i>
25 or fewer	At least 8 or more H-IB workers	7	15% or more of skilled workers (O*Net zone 4 and 5) are H-IB workers	Max - 3 1 <sup>st</sup> at 7 <sup>th</sup> FTE 2 <sup>nd</sup> and 15 <sup>th</sup> FTE 3 <sup>rd</sup> and 21 <sup>st</sup> FTE
26 - 50	At least 13 or more H-IB worker	12		Max- 7 4 <sup>th</sup> at 27 <sup>th</sup> FTE 5 <sup>th</sup> at 34 <sup>th</sup> FTE 6 <sup>th</sup> at 41 <sup>st</sup> FTE 7 <sup>th</sup> at 47 <sup>th</sup> FTE
51 or more	15% of more of workforce composed of H-IB workers	7 upwards		7 upwards

Under a tight market for skilled labor, meeting the 15% benchmark poses a serious challenge for high-skill intensive firms across the board (which we address in the following sub-section). However, the marked difference between DE and SWDE standards at the lower numbers potentially puts smaller firms at a serious disadvantage. For example, consider a tech-startup firm with 24 full-time employees. The bill’s graded provisions under the DE criteria would allow the firm to hire as many as 8 H-1Bs before it would qualify as a DE. However under the blanket 15% criterion for a SWDE, the firm would only be allowed up to 3 skilled H-1B employees (provided all the remaining 21 employees were also skilled US workers) beyond which the bill’s more onerous restrictions on wages, recruitment or non-displacement would apply.

76 The Senate bill’s language under Section 421 OUTPLACEMENT.—Section 212(n)(1)(F) (88 U.S.C. 1182(n)(1)(F)) 1 explicitly bans outplacement for dependent employers, but does not specifically mention skilled worker dependent employers. This may be oversight, but has also been noted by other legal analysts. See: Gary Endelman and Cyrus D. Mehta: “Meet Our New Friend: Who is an “H-1B Skilled Worker Dependent Employer” in Senate Immigration Bill, S.744?”

The implications would be particularly severe for startups established after the bill comes into effect. The outright 15% clause would imply that:

- If any of the firm's first six hires were H-1B skilled workers, it would qualify as an SWDE.
- In order to avoid qualifying as an SWDE, only the seventh of all skilled workers the firm hired could be an alien on an H-1B at a minimum.

These possible implications undermine the very principle of entrepreneurship and 'attracting the best and brightest' that the bill's sponsors and the Obama administration have sought to advance.

## 2. Exemption for Covered Employers

Firms may find some consolation in the bill's provisions for a 'covered employer', which exempts "intending immigrants", defined as persons for whom an employer has initiated the green card process either through the Immigrant Petition for Alien Workers (Form I-140) or the Application to Register Permanent Residence or Adjust Status (I-485).<sup>77</sup> The bill directs that all such intending immigrants be counted as US workers in the calculation for determining whether an employer is a "dependent" employer.

To qualify for 'covered employer' status, according to the bill's language, an employer must have sponsored at least 90 percent of its current employees who were beneficiaries of Labor Condition Applications in the year ending six months before the filing of an application or petition for which the number of intending immigrants is relevant.

That is to say, if an employer is filing a petition for an H-1B worker on April 10 2014, all approved labor status applications that were filed in the year ending six months prior i.e. October 10, 2012- October 10, 2013, would be relevant to this calculation. If the employer had obtained 200 approved LCAs during this one-year period, it should have sponsored 180 (90 percent) of them for green card status by April 10, 2014 to be considered a *covered employer*.

Legal experts have pointed out several drawbacks to this system:

1. The process of obtaining an LCA and further sponsoring them for permanent labor certification (PERM) comes with its own hardships.
  - a. The employer has to demonstrate that there were no minimally qualified US workers who applied for the job within a 60 day recruitment window, which is perhaps even more onerous than the condition for SWDEs which requires that no US workers were equally or better qualified.<sup>78</sup>
  - b. The PERM certification involves substantial additional costs in terms of filing and legal fees. The overall and per-employee cost can certainly add up, particularly for firms already under the DE classification who may have to pay higher visa fees.

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77 S.744 "Border Security, Economic Opportunity, and Immigration Modernization Act (Engrossed in Senate [Passed Senate])" Bill Text - The 13<sup>th</sup> Congress. Library of Congress. Available at: <http://thomas.loc.gov/cgi-bin/query/z?c113:S.744>:

78 Gary Endelman and Cyrus D. Mehta: "Meet Our New Friend: Who is an "H-1B Skilled Worker Dependent Employer" in Senate Immigration Bill, S.744?"

2. The timeframe of the 'look-back' period with respect to the relevant application and the associated delays with the PERM process require firms to make a decision on sponsoring their H-1Bs rather quickly, approximately within 3 months of hiring so as to not adversely impact their 'covered' status. Most firms may choose to initiate the I-140 certification at the time of hiring. This largely eliminates the ability for firms to try out their employees before they make a permanent investment in them.
3. The covered employer definition requires a labor-certification approval. This automatically precludes from the calculation any I-140 petitions that do not require a prior labor certification, i.e. for holders of advanced STEM degrees from US colleges, persons of extraordinary ability and outstanding researchers. Consequently, a firm gains no benefit in this calculation from hiring and sponsoring the very demographic that the bill seeks to encourage and has created several additional provisions to facilitate.

# UNDERSTANDING THE DOWNSTREAM CONSEQUENCES

## 7.1 Domestic Consequences

While IT firms and their clients have been among the most vocal opponents of the bill, there are adverse implications for the entire US private sector. These include:

### Further Skill Shortages

In Chapter 3, we have extensively discussed how contemporary research strongly supports evidence of a labor market shortage of skilled workers, particularly in the STEM fields, in the US. That this gap will only grow in the near term is also inevitable. Demand for STEM skills is exploding, with STEM-based occupations growing nearly 20% in the decade leading up to 2018,<sup>79</sup> twice as fast as employments in any other occupations. Tech firms alone expect to add 650,000 new jobs in the US, with two thirds being in high-skilled positions.

Accounting for the burgeoning demand in other non-STEM fields, the US would have to increase its number of graduates anywhere from 20-30% to keep up. Data on educational trends, however, suggests that this is highly unlikely in the near term.<sup>80</sup> US per-capita graduation rates in STEM fields tend to be declining if at all, not to mention declining workforce participation from STEM-trained workers belonging to the baby-boomer generation as they continue to retire.

Enabling access for US firms to global talent pools to adjust for this demand is an imperative. The legislative response as seen in the Immigration Bill S.744 is a classic case of ‘one step forward and two steps backwards’ in this regard. Even as the bill raises the annual cap of H-1B visas, it is apparent that the plenitude of restrictions, conditions and resulting penalties serve to shackle the ability of firms to hire the skilled workers they need.

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79 Robert D. Atkinson and Merrilea Mayo, “Refueling the US Innovation Economy: Fresh Approaches to Science, Technology, Engineering and Mathematics (STEM) Education,” The Information Technology & Innovation Foundation, December 2010.

80 Accenture Institute for High Performance, “Where Will All the STEM Talent Come From?” May 2012.



However, as we saw in our analysis, these restrictions serve as a barrier to market entry in any sector impacted by a skill shortage, which data has shown in large parts of the industry, extending beyond the traditional STEM-employers. These issues are further amplified due to locational labour-market mismatches. Data shows that a lot of future job growth in the US, especially that driven by the oil and natural gas industry, will likely come from areas where skills are not always in adequate supply.<sup>81</sup> By placing an artificial cap on non-immigrant visa workers, the bill denies firms access to the workers they need to support this growth trajectory.

## Shackling the contribution of Startups

Perhaps even more concerning is the serious disadvantage that the bill's provisions place on startups. The measures preclude the market entry of small tech startups, by severely limiting their hiring choices in the early phases of growth. This poses a serious threat of undermining the very crux of US innovation and future success that the bill's sponsors are seeking to advance.

## Stunting the Proliferation of the Remote Delivery Business Model

The emergence of the global or remote delivery business models, which are a fundamental part of the future business ecosystem, allows services-based businesses to break free of the geographic restrictions of having based in close proximity to the client. IT systems now permit this to be process to be broken up: while the bulk of a firm's workforce (the back-end) can be placed remotely to leverage locational advantages (such as lower wages and capital costs, or higher quality of living for its employees) and deliver the services, be it software, analytics or tax filings over the internet. However interfacing with a client company to fully understand its needs is still an integral component of this business model, and requires the temporary deployment of employees to the client site referred to as 'outplacing'.

Further, this practice is not the exclusive domain of offshoring firms alone. Within the US, rural locations provide distinct advantages in terms of costs for businesses. However, US firms have been largely hesitant to break their ties to urban centers, citing abundance of amenities and the advantages of agglomeration economies. The IT business has the potential to be transformative in loosening the traditional ties to geography, from enabling both IT in terms of proximity to potentially intensifying such localized labor-market mismatches.

Therefore, simply put, the proliferation of the IT sector is contingent upon the availability of adequate skills and ability to deploy this workforce as and where needed. The bills provisions put a hasty end to this nascent trend.

## Devaluing the Gains to the US Economy from the Indian ITeS Industry

The bill's targeting of Indian IT firms reflects a fundamental ignorance of the dynamics of the emerging IT-centric businesses, the contributions of this segment to the US firms or the adverse outcomes this could have on US economic. There are several issues with this approach.

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81 Thomas Black and Shruti Singh, "Caterpillar's Worker Hunt Means Welders Top Banking Pay" *Bloomberg BusinessWeek*, October 9, 2012. Available at: [http://www.sme.org/uploadedFiles/Forms/BloombergBusinessWeek\\_CaterpillarWorkerHuntTopBankingPay\\_100912.pdf](http://www.sme.org/uploadedFiles/Forms/BloombergBusinessWeek_CaterpillarWorkerHuntTopBankingPay_100912.pdf)

**First**, there is no guarantee that the loss of the Indian IT firms will be their US competitor's gain. As a high percentage of Indian IT firms will likely qualify as DE or SWDE when the rule is enforced, the severe restrictions will selectively weed out several firms who are unable to make the adjustment to comply with the new law, particularly those that are less profitable and unable to make strategic acquisitions or finance retraining and PERM sponsorships. This 'thinning of the herd' within the IT services sector will have adverse outcomes for clients, not just from project disruptions but also due to reduced choice. The resulting seller's market would allow the remaining ITeS providers to transfer increased costs of business to clients and possibly also result in an eventual deterioration in quality of services. Further, a survey conducted by HfS and Wells Fargo suggested that 24 percent of ITeS clients surveyed felt that it was either definite or highly likely that they would bring services back in-house if the measures of S.744 would come to pass. 55 percent of the respondents were unsure but would consider the option, while a mere 21 percent were definite they would not pursue this route.<sup>82</sup>

**Second**, this deprives US firms of a competitive edge in an increasingly competitive globalized economy. Besides technical expertise and specialisation, Indian IT firms provide US firms the ability to leverage low-cost backend work, reducing overall cost and improving efficiency. Reports show that more firms from the US partner with Indian IT firms than any other nation to provide world-class services worldwide.<sup>83</sup> This is indeed a two-way technology and innovation driven partnership that was only set to grow pending the enforcement of the bill's measures. There is no question that US clients that rely on these India ITeS firms will take a hit on their bottom line.

**Third**, even as they intend to increase the hiring of US workers, the restrictions in the bill are likely to result in a significant increase in off-shoring of jobs. A survey of ITeS clients found that 31 percent of respondents were highly likely or definite on the possibility of shifting a greater percentage of work offshore in response to the new rules.<sup>84</sup> Analysts at Gartner, a leading IT research and advisory firm in the US, further predict that firms may respond by offshoring as much as 90% of their work, up from the current industry average of 70%. Whether these jobs are originally held by Americans or foreign workers, it is far more beneficial to keep the jobs, along with the associated tax revenues, social security contributions and spending, within the US economy.

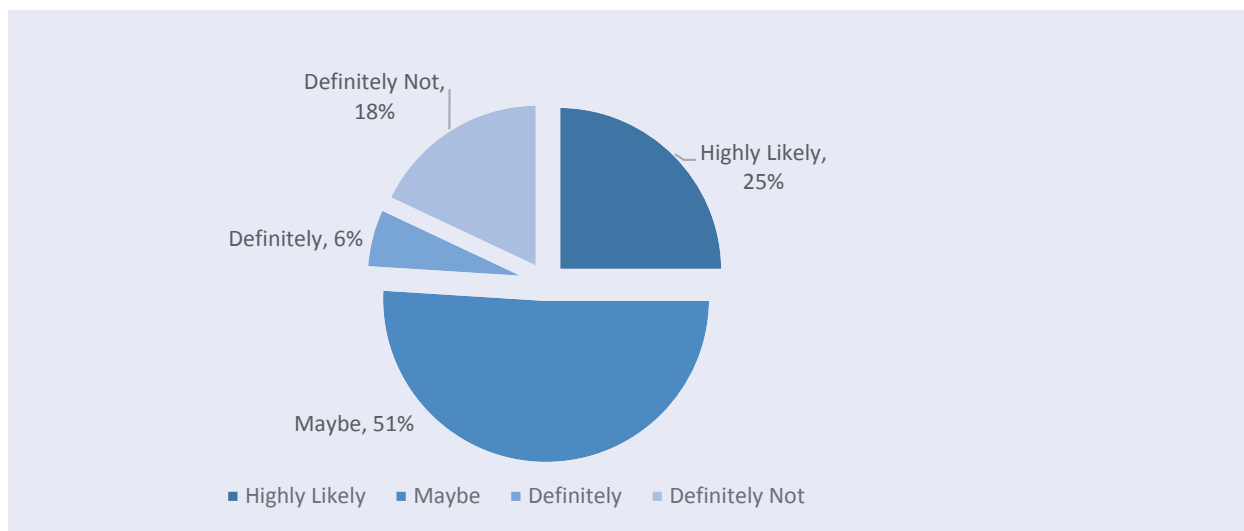
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82 "Visa Reform: Much ado about nothing, or a nuclear threat to the Indian sourcing model?" Recorded Webinar hosted by HfS Research and Wells Fargo Securities. June, 2013. Available at: <https://www3.gotomeeting.com/register/605013382>

83 Hemant K. Singh and Tincy S. Solomon, "BIT and Beyond: Advancing India-US Economic Relations", ICRIER, January 2013.

84 "Visa Reform: Much ado about nothing, or a nuclear threat to the Indian sourcing model?" Recorded Webinar hosted by HfS Research and Wells Fargo Securities. June, 2013. Available at: <https://www3.gotomeeting.com/register/605013382>

Figure 3: Use of Offshoring in Response to S.744 - ITeS Clients



Source: HFS research and Wells Fargo Securities<sup>85</sup>

**Finally**, this discounts the substantial contributions of the Indian IT industry to the US treasury and job growth. Within the US, it supports 300,000 jobs directly or indirectly and contributed over \$15 billion to the US treasury in the past 5 years.<sup>86</sup> Their total investment in the US economy as of FY 2011 was \$5 billion, and is likely to have grown in light of subsequent acquisitions.

While further sector-specific studies may be done, with the prevailing low unemployment rates and the low likelihood of US STEM graduates meeting demand, it can be surmised that the misplaced attempts to protect US workers only serve to exacerbate the adverse impact of the STEM shortage for US employers that the first segment of Title IV (the increase in visa caps) aims to achieve. They create barriers to entry for new firms and startups, and finally, in seeking to preclude the Indian IT services sector, may potentially diminish the overall competitiveness of the US economy.

## 7.3 International Consequences

In crafting this legislation, US lawmakers have so far largely ignored the adverse foreign policy implications of the bill's provisions, according them, at best, marginal consideration after overriding domestic priorities. These measures, if enforced, along with the unfavorable outcomes that are likely to follow, will undermine the perception of the US as a desirable destination for foreign investment at the very least for the IT services sector.

<sup>85</sup> Ibid.

<sup>86</sup> Hemant K. Singh and Tincy S. Solomon, "BIT and Beyond: Advancing India-US Economic Relations", ICRIER, January 2013.

## I. Impact on the Indian Economy

The Indian IT/ITES industry trade body NASSCOM has estimated that the bill may wipe out as much as a quarter of the industry's revenues in the US, which are currently estimated at \$45 billion, accounting for nearly 2.5% of India's GDP. A more conservative study by JP Morgan concluded that the bill, if passed in its current form, would cause a direct loss to India's IT sector of \$2.6 billion, but would cause the loss of approximately \$6 billion, or 0.4% of India's GDP, when downstream effects are factored in.<sup>87</sup>

The importance that the Indian Government has accorded to the bill's adverse implications is evident from this issue being raised at bilateral meetings at the very highest levels. Following demarches made by Indian Commerce Minister Anand Sharma and Finance Minister P. Chidambaram with their counterparts, Prime Minister Manmohan Singh raised the issue with President Obama during their September 27, 2013 Summit meeting in Washington D.C.<sup>88</sup> He is said to have stressed that any restrictions on the movement of IT services will have an adverse impact on India.

Following this meeting, in his address to business leaders in New York later on the same day, the Indian Prime Minister warned that "the inability of IT companies to operate in the US market would not only affect our economy, but also the climate of opinion in India about the economic partnership with the US," while noting that India on its part had taken significant steps to address a number of tax-related concerns of US companies that have wholly-owned subsidiaries in India.<sup>89</sup>

A punishing outcome for India's IT services industry is likely to invite an adverse response in India, undoing the recent progress made by the Indian government in addressing grievances of American businesses on issues ranging from tax policy to market access. As both the US and Indian governments look to revive economic growth, they can ill-afford the consequences of plunging economic relations into a gridlock and foregoing the mutual benefits of enhanced bilateral trade and investment.

## 2. Possible Infringement of US Commitments under GATS

As a member of the WTO, the US is bound by its commitments under the General Agreement on Trade in Services (GATS) that came into effect in January 1995. In addition to general obligations, the US chose to offer specific binding commitments with regard to the entry of workers from other Member states under Mode 4, which guarantees both ease of entry (under applicable domestic law) and equitable competitive opportunity for these workers. Commitments in the US schedule relevant to the discussion specifically include:

Intra-corporate transfers of managers, executives and specialists for a period of up to 5 years (three years initially, with the possibility of a two-year extension);<sup>90</sup>

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87 Anirban Sen, "US Immigration Bill May Erode India's GDP By .4%," *LiveMint*, June 25, 2013, available at <http://www.livemint.com/Industry/T8a6cjcvm06z7vGU068RQN/US-immigration-Bill-may-erode-Indias-GDP-by-04.html>.

88 "Prime Minister Manmohan Singh flags India's concerns over US immigration law changes" *Economic Times*, September 28, 2013, [http://articles.economicstimes.indiatimes.com/2013-09-28/news/42481611\\_1\\_immigration-laws-indian-it-concerns](http://articles.economicstimes.indiatimes.com/2013-09-28/news/42481611_1_immigration-laws-indian-it-concerns)

89 Ibid.

90 Jochum Shore & Trossevin, PC, "Legal Analysis: Proposed Changes to Skilled Worker Visa Laws Likely to Violate Major US Trade Commitments" National Foundation for American Policy, June 2010 [http://www.nfap.com/pdf/GATSLegalAnalysis\\_NFAPPolicyStudy\\_June2010.pdf](http://www.nfap.com/pdf/GATSLegalAnalysis_NFAPPolicyStudy_June2010.pdf)

Assignment of Managers or executives engaged in establishing a commercial presence, with operations to begin within one year;<sup>91</sup>

Entry of up to 65,000 persons annually (worldwide) who are engaged in “specialty occupations” as set out in 8 USC § 1101(a)(15)(H)(i). Entry is limited to three years and subject to compliance with labour certification requirements, including: (1) wages must be the greater of the actual wage paid by the employer to individuals with comparable qualifications, or the prevailing wage for the occupation; and (2) the employer must not have laid off or otherwise displaced workers in the subject occupation during the period 90 days prior to and 90 days following the filing of the visa petition.<sup>92</sup>

The proposed provisions of Title IV of S.744 and its House companion bill HR. 15 may infringe upon specific US commitments in this regard and risk disputes and retaliation from other member states. A brief analysis of provisions of greatest concern is given in the table below.

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91 Ibid.

92 Ibid.

Table 5: Analysis of Potential GATS Violations in Title IV

Section	US Commitment under GATS	Potential Rationale for Violation
Wages	Wages for such temporary workers in “specialty occupations” to be the greater of the actual or prevailing wage	Proposed new wage benchmarks could potentially be higher (i.e., more restrictive) than both the actual and prevailing wage commitments made by the US under Article XX of GATS
Non-Displacement	Required certification of no layoffs or other displacements is to cover the period 90 days before and after the filing of the visa petition	By doubling the period from 90 to 180 days, the legislation would significantly increase the restriction on market access through H-1B visas, inconsistent with US commitments under Article XX of GATS
Outplacement	a. 90-day no-layoff commitment as above and b. General commitment to equitable market access	Violates layoff commitment as above and also US commitments to market access under Mode 3
Limitation on Percentage of H-1B and L-1 workers	Scheduled worldwide limitation of 65,000 on H-1B workers consistent with current US law	The 50/50 rule may be interpreted as an additional numerical limitation in excess of the US commitments under GATS
Restrictions on L-1 Personnel engaged in establishing a new office	Managers and executives and intra-corporate transferees provided initial entry of up to three years, with the possibility of a two-year extension with the onus of proving “the acquisition of physical premises for the entity that shall commence its business operations within one year of the date of entry of that person.”	Certain criteria for granting and extending the L-1 visa, and the restriction on two or more L-1 visas in two years, are in excess of US commitments under GATS
Visa Fees	Members ensure that “all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner.”	High visa fees, like a high tariff, could affect the provision of services through the presence of natural persons, in violation of Mode 4 commitments under Article XVI of GATS

It is clear that as it stands at present, S.744 is detrimental to US economic interests, whether in terms of addressing its skill shortage in critically important sectors, promoting entrepreneurship, creating a balanced investment climate, or in furthering ties with key US partners such as India.

To eliminate these adverse impacts, alternatives to the Senate Bill need serious consideration by the House of Representatives. The solution may lie with the House’s very own bill on skilled visa reform known as H.R.2131.

## ASSESSING THE ALTERNATIVE: H.R.2131 - THE SKILLS VISA ACT

Even as the Senate voted on S.744 in the late spring of 2013, the House of Representatives was working on its own parallel bill to address issues with skilled employment visas.

Introduced by House Oversight and Government Reform Committee Chairman Darrell Issa (R-CA) and House Judiciary Committee Chairman Bob Goodlatte (R-VA) before the House of Representatives on May 23, 2013, the SKILLS Visa Act, or H.R.2131, proposes to “spur job creation, economic growth, and American competitiveness by increasing and improving high-skilled immigration programs.”

The bill was passed by the House Judiciary Committee on June 28, 2013, a mere two days after S.744 was passed by the Senate. The bill has, however, lain dormant since, as Democratic members of the House subsequently introduced and are pursuing the passage of comprehensive immigration reform (H.R.15).

Like S.744, the SKILLS Visa Act addresses some of the salient issues with skilled immigration and visa programs, such as increasing the availability of skilled workers, improving enforcement of visa rules, and addressing immobility and backlogs.

Towards this end, H.R.2131 increases the annual cap for Green cards, while eliminating backlogs and allocating two new categories for aliens with advanced STEM degrees. Like the Senate bill, it raises the annual cap of H-1Bs, favouring a static level of 155,000 visas as opposed to an escalator system, while also increasing the number of exemptions for advanced STEM degrees to 40,000 annually. At the same time, it creates a provision that obligates a portion of visa fees collected towards STEM education and training programs for Americans. To enforce compliance with visa rules, it gives the DOL authority to conduct random audits and issue subpoenas, in addition to current investigatory powers.

H.R.2131 has received its share of criticism, particularly for its STEM-centrism, where most of the new sops are reserved exclusively for STEM-trained professionals.<sup>93</sup> The bill has also been called out for compromis-

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93 Graduate Management Admission Council, “Summary of the Skills Visa Act (HR 2131)”. Available at: <http://www.gmac.com/about-us/government-outreach/skills-visa-act-hr-2131.aspx>

ing on some forms of family-based immigration. For example, the bill eliminates the 65,000 green cards under the 4<sup>th</sup> preference category for siblings of US citizens, reallocating these to other categories.

However, the Skills Act particularly distinguishes itself from the Senate Bill S.744 in that it seeks to address the most pressing issues pertaining to skilled visa reform without prejudiced interventions such as the 50-50 workforce cap, ban on the outplacement practice, or other onerous restrictions on ‘dependent employers.’ As such, by avoiding the use of distinctions on the basis of arbitrary benchmarks, H.R.2131 limits the scope for unequal outcomes for firms in the US market.

## Significant of Provisions of H.R. 2131

- Increases Annual Number of Green Cards from 140,000 to 235,000 per year.
- Eliminates backlogs and country caps for employment-based green cards.
- Increases Annual H-1B cap to 155,000, plus an exemption for 40,000 holders of advanced STEM degrees.
- Creates three levels of prevailing wages that employers must pay H-1B and L-1 non-immigrants.
- Increases DOL authority for conducting random audits and issuing subpoenas.

## Potential Concerns Expressed by Critics

- STEM-centric at the expense of graduates of other fields, as it provides additional green card quotas and exemptions reserved for STEM graduates and professionals.
- Compromises on some aspects of family-based immigration.
- Restricts opportunities for students under Optional Practical Training (OPT) by extending wage laws to OPT.

That there is room for improvement in the bill’s provisions is undeniable, and if the bill should be progressed, it is inevitable that it may well undergo some changes. Nonetheless, H.R.2131 follows a more evenhanded approach to skilled visa reform from both business and international relations perspectives. In the coming months, if the House should choose a piecemeal approach to immigration reform, H.R.2131 provides a better foundation from which to carve out a balanced and effective legislation for skilled alien workers and their employers in the United States.

A detailed comparison between H.R.2131 and S.744 can be seen at Annexure 3 of this report.



# CONCLUSIONS AND THE WAY FORWARD

## 9.1 Overall Impressions

The origins of Title IV of the Senate bill S.744 and its counterpart in the House H.R. 15 can in many ways be traced to the decline of the US as a global nuts and bolts manufacturing powerhouse, with the concurrent and growing prevalence of innovation and high-technology as the new hallmark of the US economy.

The increasing competition for STEM skills from non-traditional occupations has led to an overall shortage of STEM-trained workers to drive US innovation. At the same time, the increasing employment of skilled foreign talent to supplement the domestic workforce, while reaping tremendous rewards for the US, has presented a wide array of policy challenges. Foremost among these has been domestic concern about the system's propensity for misuse, leading to wage discrimination against the native workforce.

However, political compulsions and protectionist urges have yielded measures that are at cross-purposes with one-another. On one hand, the bill takes a stand on addressing the STEM shortage by expanding the annual cap of H-1B workers and substantially increasing avenues to lawful permanent residency for skilled STEM workers. On the other, the bill highly regulates access to this expanded pool of workers, raising both the number and intensity of restrictions on hiring H-1B workers by certain types of firms, Indian IT services firms in particular.

More specifically, the bill fails to ensure a uniform and universal impact across industries in the economy. A handful of loopholes and exceptions inserted in the bill's language to placate special interest lobbies undermine the bill's intent and contribute to its discriminatory character.

A discernible preoccupation with the purported abuses of the Indian IT services industry is where the bill's intent to address alleged misuse of the H-1B programme descends to protectionism. The outplacement clause, perhaps the bill's most exacting and narrow restriction, is targeted at a crucial Indian IT industry-specific practice which in fact optimizes efficiency and efficacy in the delivery of services to US clients. The bill's considerable safeguards against wage arbitrage and unbridled hiring of foreign nationals sufficiently

eliminate the incentive for misuse. As such, the inclusion of such onerous restrictions is punitive and arguably unwarranted.

The bill's wage and fee provisions also add protectionist barriers by providing indigenous employers a significant cost advantage over Indian employers of non-immigrant workers.

The bill's provisions have significant international implications, first and foremost for India. Many of the leading firms within the global IT services industry also happen to be headquartered in India and form the backbone of the recent successes of the Indian economy. The bill's measures effectively undermine one of the most promising of US partnerships, in terms of both strategic and economic value.

## 9.2 The Way Forward

The "Skills Visa Act", or H.R.2131, being considered by the House prior to the introduction of the comprehensive immigration reform bill H.R. 15, presents a counterpoint to S.744. Even as it addresses several of the same pressing issues with regard to the H-1B cap, worker mobility, enforcement and oversight, the bill contains virtually none of the measures that are discriminatory or place an onerous burden on business, such as the outplacement clause, the DE and SWDE provisions, and visa fee hikes.

While the piecemeal bill's perceived omission of some of the protectionist provisions may see resistance from some quarters, H.R.2131 presents a far better foundation to build upon and reconcile the objectives on skilled visa reform for both the House and Senate.

## 9.3 The Current Prospects of Skilled Visa Reform in the US Congress

The impasse over the comprehensive immigration bill has carried into the New Year. Even so, despite the efforts of advocacy groups and the Indian government, Title IV remains one segment of the bill that has so far received little attention from either of the two US political parties. The US Administration and White House have shown a disinclination to act upon India's requests to revisit aspects of the legislation, in view of the risks this would create for the "Path to Citizenship" measures which are part of the comprehensive bill.

Further, there is an evident lack of a constituency among US policymakers to address Indian concerns with the provisions of Title IV, even among members of the India Caucus in Congress. Of the 135 members of the India Caucus, 63 have not only supported the bill but have also co-sponsored H.R.15 in a measure of serious support.<sup>94</sup> According to House Democratic Leader Nancy Pelosi, so far 187 Congressmen are on board, including two Republicans, in the 435-member House. A further 28 Republican Congressmen have expressed their support for the path to citizenship provisions within the current bill.<sup>95</sup>

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94 Sirohi, Seema, "New US Law: Immigration Bill will decimate Indian IT companies" Economic Times, November 13, 2013 [http://articles.economictimes.indiatimes.com/2013-11-13/news/44030944\\_1\\_h-1b-h1-b-india-caucus](http://articles.economictimes.indiatimes.com/2013-11-13/news/44030944_1_h-1b-h1-b-india-caucus)

95 Ibid.

In contrast, a small but growing number of US clients of Indian IT services companies as well as US firms with significant commercial interests in India, have urged US policymakers to consider changes to the bill as it advances in the House.

Going by current indications, Indian IT companies and the Indian government have an uphill task to ensure that their concerns regarding S.744 and H.R.15 will be addressed. Inattention to Indian concerns will have adverse consequences for India-US economic relations. India may well become less receptive towards the concerns of US business on trade and investment issues. After all, for all the regulatory constraints and difficulties of doing business in India which have recently been the subject of strong contestation by the US side, the Indian parliament has not passed legislation which creates discriminatory barriers against US companies operating in India.



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# ANNEXURES TO THE REPORT

## Annexure I:

### Understanding the Difference between the Dependent Employer (DE) and Skilled Dependent Employer (SWDE) Classifications

According to the USCIS factsheet, an employer is considered H-1B-dependent if it has:

- 25 or fewer full-time equivalent employees and at least eight H-1B nonimmigrant workers; or
- 26 - 50 full-time equivalent employees and at least 13 H-1B nonimmigrant workers; or
- 51 or more full-time equivalent employees of whom 15 percent or more are H-1B nonimmigrant workers

The Dependent Employer Classification therefore focuses on the number of H-1Bs as a proportion of a firm's total workforce (including both US and H-1B workers).

The new skilled-worker dependent employer classification is concerned only with the *skilled* portion of an employer's workforce, namely those that fit the definition of job zones 4 and 5 of O\*Net. It seeks to ascertain the proportion of this skilled component of the workforce that is populated by H-1B workers.

As each tech-firm's workforce often includes a mix of lower-skilled or unskilled workers (mailroom workers, receptionists and so on), the skilled component is, in most cases, a subset of the firm's total workforce. At the same time, most H-1B workers in any STEM-associated business would classify under the job zones 4 and 5.

What the SWDE effectively does is dramatically lower the denominator in the dependency calculation (from total workforce to skilled workforce) while in most cases the numerator has little to no change (total H-1Bs to *skilled* H-1Bs).

Firms that have steered clear of the DE classification in the past, may suddenly find themselves falling under the ambit of the new SWDE classification, as the example below shows.

**Example: The implications of the new *skilled-worker dependent employer* (SWDE) classification**

A firm has a total of 10,000 full-time employees. Of these, 1,500 would be considered ‘skilled’ as per O\*Net job zones 4 and 5. The firm has hired 600 H-1Bs at various high-skilled positions to supplement its workforce.

Total Workforce	10,000
Skilled Employees*	1,500
H-1B Employees	600

\*Classifiable under O\*Net job zones 4 and 5

**Ascertaining Dependency**

**Dependent Employer:**

H-1B dependency = Total H-1B Employees / Total full-time workforce

H-1B Dependency = 10,000/600 = 6%

**Skilled-worker dependent employer:**

= Total H-1B Employees/ Total Skilled employees

= 600/1500 = 40%

As H-1Bs constitute a mere 6 percent of its total workforce, the firm is well clear of qualifying as a *dependent employer*. However, from the perspective of *skilled worker dependency*, the firm’s H-1B employees constitute 40% of its skilled workforce. As such, under the rules proposed by S.744, it would qualify as a ‘H-1B skilled worker dependent employer’ and be subject to additional hiring restrictions for additional H-1Bs.

## Annexure 2:

### Enumerating the Costs of Sponsoring an H-1B worker for PERM<sup>96</sup>

According to a NFAP report, “in addition to paying the required wage, employers must pay legal and government fees for an H-1B that could reach \$9,540 for an initial petition and another \$9,540 for an extension, according to the American Council on International Personnel and Society for Human Resource Management.<sup>97</sup> The estimated cost to sponsor a foreign national all the way from an H-1B petition through the green card process for permanent residence could reach approximately \$50,000.”<sup>98</sup>

Employer Cost for H-1B Visas	Amount
Attorney Fees	\$1,000 to \$3,000
Training and Scholarship Fee	\$1,500 (\$750 if fewer than 25 employees)
Anti-Fraud Fee	\$500
Application Fee	\$325
Consular Processing	\$190
Visa Fee	\$0 to 800 (based on reciprocity)
Premium process Fee	\$1,225 (optional)
Employers 50% of U.S. Workforce in H-1B/ L-1 Status	\$2,000
H-4 Dependent	\$740 to \$1,630
H-1B Extension (potentially all the same fees apply)	\$1,325 to \$9,540
<b>Total H-1B Fees</b>	<b>\$2,575 to \$20,710</b>
<b>Total Cost to Sponsor Foreign national for Permanent Residence (Green Card)</b>	<b>\$8,300 to \$30,904 (not incl. family members)</b>

Source: Stuart Anderson, “H-1Bs Essential to Attracting and retaining Talent in America”, National Foundation for American Policy, May 2013.

96 As given in: Stuart Anderson, “H-1Bs Essential to Attracting and retaining Talent in America”, National Foundation for American Policy, May 2013. Available at: <http://www.nfap.com/pdf/NFAP%20Policy%20Brief%20H-1B%20Visas%20May%202013.pdf>

97 Ibid.

98 Ibid.

# Annexure 3:

## Comparison of S.744 and H.R.2131<sup>99</sup>

### Comparison of Border Security, Economic Opportunity, and Immigration Modernization Act (S.744) and Skills Visa Act (H.R. 2131)

SELECT HIGH-SKILLED IMMIGRATION PROVISIONS			
Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
<b>Green Card Backlog (Employment)</b>	<p>140,000 annual limit, which includes spouses and family members. Actual number of workers is approximately 65,000.</p> <p>Backlog is years for most employment-based green card applicants with employer sponsor who has tested local labor market; for example:</p> <p>Current EB3 backlogs are India 10½ years Rest of World 4½ years</p> <p>Current EB2 backlogs are China 4 years India 5½ years</p>	<p>Retains the 140,000 base, but reduces (or eliminates) the green card backlog through a number of exemptions, including:</p> <ul style="list-style-type: none"> <li>Exempting existing EB-1 immigrants from annual cap;</li> <li>Exempting all PhDs from annual cap (not just STEM);</li> <li>Exempting all advanced degree STEM holders from US universities;</li> <li>Recapturing unused green cards from prior years (approx. 210k);</li> <li>Exempting all family members of foreign workers; and</li> <li>Eliminating the per-country limits.</li> </ul> <p><b>Summary:</b> This will reduce or, in many cases, eliminate the green card backlog for employment-based green card applicants. STEM graduates from US universities will have a fast track to a green card.</p>	<p>Retains the 140,000 base. Creates a new visa category and allocates up to 55,000 additional green cards for:</p> <ul style="list-style-type: none"> <li>Graduates of US universities with PhD in STEM field;</li> <li>Graduates of US universities with master's degree in STEM field.</li> </ul> <p>Allocates an additional 30,000 green cards evenly divided between (a) EB-2 (professionals with advanced degrees and persons with exceptional ability) and (b) EB-3 (professionals with a bachelor's degree and others). Added at mark up: a set-a-side of 4,000 green cards for nurses.</p> <p>Eliminates the per-country limits for employment-based immigration.</p> <p><b>Summary:</b> The legislation results in an increase of 85,000 employment based green cards per year. The legislation does not recapture any unused green cards from prior years. It is expected that green card backlogs will remain, particularly for EB-3 immigrants.</p>

<sup>99</sup> Adapted from analysis created by: US Chamber of Commerce: “Brief Summary of Certain High Skilled Green Card and Temporary Worker Program Reforms in the 113th Congress H.R. 2131 (House High Skilled bill) and S.744 High Skilled Provisions found in Title II (Green Cards) and Title IV (H-1B, L-1, F-1): Available at: [http://immigration.uschamber.com/uploads/sites/400/summary\\_house\\_senate\\_high\\_skilled\\_comparison\\_table\\_8\\_5\\_2013.pdf](http://immigration.uschamber.com/uploads/sites/400/summary_house_senate_high_skilled_comparison_table_8_5_2013.pdf)

**SELECT HIGH-SKILLED IMMIGRATION PROVISIONS**

Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
<b>F-1 Student Dual Intent</b>	Foreign students may not begin the green card process while in student status and must document intent to return home when beginning studies and whenever requesting updated student visa stamp.	Permits “dual intent” for foreign students so that an employer can start the green card process while the student is still in school or working pursuant to Optional Practical Training.  This may allow certain graduates of US universities to avoid the H-1B visa category and move straight to a green card.	Permits “dual intent” for foreign students who are enrolled in course of study in a STEM field.
<b>H-1B Cap Increase</b>	Current H-1B base cap is 65,000 per year. Up to 20,000 US Master’s degree or higher (regardless of field) are exempt from the cap.  Cap was hit in the first five days of FY 2014, and has been hit before the end of the fiscal year since FY1997 except FY2001-2003, when the cap was 195,000.  H-1B workers at institutions of higher education or related or affiliated nonprofit entities, nonprofit research organisations or governmental research organisations are cap exempt.	Raises the H-1B cap by setting a new base of at least 115,000, which could adjust up to 180,000. If the cap is reached before the end of the first quarter of the fiscal year, additional visas (up to 20,000 depending on how early the cap is met) will be made available immediately, and the annual ceiling would be higher in the subsequent fiscal year. No increases to H-1B numerical limits can occur if national occupational unemployment in the “management, professional and related occupations” averaged > 4.5% in prior 12 months. In last 5 years, H-1B cap would not have risen in FY11, FY12, but would go up in FY10, FY13, FY14.  Current Master’s degree exemption would be increased from 20,000 to 25,000 but limited to STEM grads.	Raises the H-1B annual limit to 155,000. The annual cap does not change from year to year.  Increases the exemption for graduates of US universities with graduate degrees (Masters or above) to 40,000 for a total of 195,000 annually, but limits eligibility to STEM graduates.
<b>H-1B Portability</b>	No grace period under current law after ending H-1B employment.	Creates a 60-day grace period for H-1B workers who lose their job to obtain H-1B status through another employer.	No provision in bill.



**SELECT HIGH-SKILLED IMMIGRATION PROVISIONS**

Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
<b>Green Card Portability</b>	A worker may change jobs or employers if the adjustment of status application (last stage) has been pending for at least 6 months.	Any employee who has an approved labor certification or immigrant petition may change jobs or employers without losing their place in line for a green card. Any employee with an approved immigrant visa petition may change jobs or employers without losing that eligibility, provided that the new job is in the same or a similar occupational classification.	Any employee who is the beneficiary of a labor certification, or an employment-based immigrant visa petition that was approvable when filed, shall retain his or her place in line (priority date).
<b>Early Adjustment Filing</b>	A worker may not file an adjustment of status application until the priority date is current.	<p>A worker may file an adjustment of status application irrespective of whether a green card number is available (upon payment of \$500 fee).</p> <p>This ensures that if there is a green card backlog, an employee may file an adjustment of status application while waiting for the green card.</p>	Provision added in mark up to allow worker to file adjustment of status application irrespective of whether a green card number is available (\$500 fee if visa number unavailable). Different language than Senate bill but is expected to cover most employment- authorized principals, and their dependents, filing for adjustment based on employment-based visa petition.
<b>Wage Levels for H-1B Workers</b>	<p>4-tier wage levels based on job responsibilities and requirements for the position. The government publishes a wage survey that includes four tiers, ranging from entry-level up to fully competent.</p> <p>Level 1 wage is often at about the 15<sup>th</sup> percentile of surveyed wages.</p>	<p>Collapses the current 4-tier wage level system into a new 3-tier system.</p> <p><b>New Wage System:</b></p> <p>Level 1 = mean of bottom 2/3 wages (but no less than 80 percent of Level 2)                      Level 2 = mean of all wages                      Level 3 = mean of top 2/3 of wages</p> <p>Dependent employers must pay the new Level 2 wage (mean wage for all workers in the classification), irrespective of the job responsibilities or requirements for the position.</p>	<p>Collapses the current 4-tier wage level system into a new 3-tier system. Also applies to TNs, F-1 students working on OPT (Optional Practical Training), and most L-1Bs (any L-1B in the US an aggregate period of 6 months over 24 months).</p> <p><b>New Wage System:</b></p> <p>Level 1 = mean of bottom 2/3 wages (but no less than 80 percent of Level 2)                      Level 2 = mean of all wages                      Level 3 = mean of top 2/3 of wages</p> <p>In mark up, the restrictions in the introduced bill were stricken that had limited level 1 wages solely to those hires who had earned a US degree and had graduated less than 12 months before hire. In mark up, explicit access to private surveys was added, as an alternative to the 3 prevailing wage levels. In mark up, an exception to the prevailing wage requirement was passed that allows an employer to pay according to its</p>

**SELECT HIGH-SKILLED IMMIGRATION PROVISIONS**

Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
			<p>internal wage scale in those circumstances where 80% of workers in the occupation in which the foreign H-1B, TN, F-1 OPT or L-1B worker is hired will be employed are American in the area of employment. In such a circumstance, the employer can pay the foreign worker in accordance with the “actual wages paid by the employer to all other individuals with similar experience and qualifications for the specific employment in question.” However, for any employer with more than 25 employees hiring an H-1B, TN or F-1 OPT hire, the “80% exception” explicitly requires that wages paid be no lower than the mean of the lowest one-half of wages surveyed (which is slightly higher than current level 1 wages but lower than current level 2 (new level 1) wages).</p>
<p><b>Wage Levels for L-1 Transfers</b></p>	<p>Nothing in current law.</p>	<p>No provision in bill.</p>	<p>Requires employer to pay L-1B workers the higher of the actual wage level or either a private wage survey wage level or the new three level prevailing wage system:</p> <p>Level 1 = mean of bottom 2/3 wages (but no less than 80 percent of Level 2)                      Level 2 = mean of all wages                      Level 3 = mean of top 2/3 of wages</p> <p>Obligations are triggered if employee will be in the US for a cumulative period in excess of 6 months over a 3 year period.</p> <p>Employer may take into account currency in home country, employer-provided housing or allowance, transportation allowance, or other benefits as an incident of the assignment.</p> <p>Exception added in mark up if 80% of workers in the occupation in which L-1B will be employed are American in the area of employment, in which case the employer can pay according to its internal wage scale (“actual wages paid by the employer to all other individuals with similar experience and qualifications for the specific employment in question”).</p>

**SELECT HIGH-SKILLED IMMIGRATION PROVISIONS**

Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
<b>Degree Evaluation</b>	Nothing in current law.	No provision in bill.	Secretary of State shall verify the authenticity of any foreign degree.
<b>Bona Fide Business</b>	Nothing in current law.	No provision in bill.	Requires H-1B employer to be licensed with any applicable State or local business licensing requirements.  Requires H-1 employer to have gross assets of at least \$50,000.
<b>Subpoena Authority</b>	Nothing in current law.	No provision in bill.	Secretary of Labor is authorized to issue subpoenas as may be necessary to ensure employer compliance.
<b>B-1 in Lieu of H1B</b>	Authorized by Department of State policy guidance (Foreign Affairs Manual).	No provision in bill.	Prohibits issuance of a B-1 visa if applicant will provide services in an H-1B specialty occupation.
<b>Filing Fees for High Volume Users</b>	If company has more than 50 employees in the US and more than 50 percent H-1B or L-1, employer is required to pay an additional \$2,250 for certain L-1 petitions and \$2000 for certain H-1B petitions.	Eliminates the current level of “50/50” fees (imposed by PL 111-230, passed Aug 2010) and replaces with the following: <ul style="list-style-type: none"> <li>For FY2015 through FY2024, company must pay additional \$5,000 per L-1 and H-1B application if more than 30 percent and less than 50 percent of company’s employees are H-1B or L-1.</li> <li>For FY2015 through FY2017, company must pay additional \$10,000 per L-1 and H-1B application if more than 50 percent and less than 75 percent of company’s employees are H-1B or L-1.</li> </ul>	No provision in bill.

**SELECT HIGH-SKILLED IMMIGRATION PROVISIONS**

Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
<b>50/50 Numerical Limitations</b>	There are no numerical limits based on visa usage.	<p>If company employs more than 50 workers:</p> <ul style="list-style-type: none"> <li>• In FY2015, no more than 75 percent of the US workforce may be in H-1B or L-1 status.</li> <li>• In FY2016, no more than 65 percent of the US workforce may be in H-1B or L-1 status.</li> <li>• In FY2017, no more than 50 percent of the US workforce may be in H-1B or L-1 status.</li> <li>• FY2017 and after, 50 percent limit on H-1B and L-1.</li> </ul>	No provision in bill.
<b>Non-Displacement Attestation</b>	<p>Nothing in current law for non-dependent companies.</p> <p>Dependent employer (more than 15 percent H-1B) must attest that it did not displace and will not displace an essentially equivalent US worker within the period 90 days before and after the filing of the petition. The employer does not have to attest if the H-1B worker will be paid at least \$60,000 and/or has a master's or higher degree.</p>	<p>Every employer must attest that it is not:</p> <ul style="list-style-type: none"> <li>• displacing a public school teacher;</li> <li>• displacing a US worker at a federal, state, or local government entity where the government entity directs and controls the work of the H-1B worker (excluding universities);</li> <li>• filing the H-1B petition with the intent or purpose of displacing a specific US worker.</li> </ul> <p>H-1B skilled worker dependent (more than 15 percent of skilled positions are filled by H-1B workers) must attest that that the employer did not displace and will not displace a US worker during period 90 days before or after the petition is filed.</p> <p>An employer that is dependent (with more than 15 percent H-1B workers in total) must attest that the employer did not and will not displace a US worker for 180 days before or after the petition is filed.</p>	No provision in bill.

**SELECT HIGH-SKILLED IMMIGRATION PROVISIONS**

Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
<b>US Worker Recruiting Attestation</b>	<p>Nothing in current law for non -dependent companies.</p> <p>Dependent employer (more than 15 percent H-1B) must attest that it has taken good faith steps to recruit and that it offered the job to any US worker who applied and was equally or better qualified. The employer does not have to attest if the H-1B worker will be paid at least \$60,000 and/or has a master’s or higher degree.</p>	<p>All H-1B employers must document recruitment in the occupation using industry-wide standards, and all H-1B employers must advertise on the DOL Internet site for 30 days.</p> <p>Requires an employer that is an H-1B skilled-worker dependent (more than 15 percent of skilled positions are filled by H-1B workers) to attest that it offered the job to any US worker who applied and who was equally or better qualified for the job.</p> <p>Recruitment attestation applies at the time of initial hire and not for extensions of stay with the same employer.</p>	No provision in bill.
<b>H-1B Third Party Placement (outplacement)</b>	Nothing in current law.	<p>Every employer must pay a \$500 fee for each petition filed on behalf of an H-1B worker that will be placed at a third-party worksite.</p> <p>An H-1B dependent employer (more than 15 percent of the workforce composed of H-1B workers) may not place an H-1B worker at a third- party worksite.</p>	No provision in bill.
<b>L-1 Third Party Placement (outplacement)</b>	No restriction on placing an L-1 worker at a third-party site if the employer will control and supervise the L-1 worker and the placement does not constitute labor for hire.	<p>Every employer must pay a \$500 fee for each petition filed on behalf of an L-1 employee that will be placed at a third-party worksite.</p> <p>An L-1 dependent employer (more than 15 percent L-1) may not place an L-1 worker at a third party worksite.</p>	No provision in bill.

**SELECT HIGH-SKILLED IMMIGRATION PROVISIONS**

Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
<b>LCA Review</b>	<p>DOL may only review LCAs for “obvious errors or inaccuracies”</p> <p>DOL must certify LCA within 7 days.</p>	<p>LCA’s would be reviewed for completeness and “evidence of fraud or misrepresentation of material fact.”</p> <p>Bill would extend LCA processing time period from 7 to 14 days. However, an employer could proceed with an H-1B petition without waiting for LCA certification.</p>	No provision in bill.
<b>DOL Investigation Triggers</b>	<p>DOL may only investigate when:</p> <ul style="list-style-type: none"> <li>• There is a complaint from an aggrieved party</li> <li>• DOL receives specific, credible information from a reliable (i.e. known) source (other than DHS)</li> <li>• Secretary of DOL personally certifies that there is reasonable cause to believe employer is not in compliance.</li> </ul>	<p>Removes most limitations on DOL’s ability to conduct an audit of an H-1B employer. For example:</p> <ul style="list-style-type: none"> <li>• Allows DOL employee to be a “credible source,” which means that employees can initiate investigations.</li> <li>• USCIS Director shall provide information to the DOL regarding any information contained in the materials submitted by employers of H-1Bs as part of the adjudication process that indicates the employer is not complying with the law, and DOL may initiate an investigation based on receipt of that information.</li> </ul>	DOL may conduct random audits of H-1B or L-1 employers.
<b>DOL Statue of Limitations</b>	Complaint must be filed within 12 months of when the alleged violation occurred.	Complaint must be filed within 24 months of when alleged violation occurred.	No provision in bill.
<b>DOL Fines for LCA Violations</b>	Civil monetary penalties range from \$1,000 per violation, to \$35,000 per violation.	Doubles the existing fine structure for most violations and clarifies that workers are entitled to pay back for any violations.	No provision in bill.
<b>Mandatory DOL Audits</b>	No mandatory DOL audits.	DOL may conduct voluntary surveys of all employers. DOL is required to conduct annual audits of any employer that has more than 100 employees, if more than 15 percent are H-1B or L-1 status.	No provision in bill.

SELECT HIGH-SKILLED IMMIGRATION PROVISIONS			
Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
<b>W-2 Submission</b>	Nothing in current law.	An employer must file a W-2 individual wage report with USCIS on an H-1B employee's subsequent extension. Upon request from DHS, IRS and/or SSA may be asked to confirm whether the W-2 filed with USCIS matches the W-2 filed with IRS/ SSA.	No provision in bill.
<b>STEM Fee for Labor Certification or Immigrant Petition</b>	Nothing in current law.	An employer would pay a \$1,000 fee with each labor certification, which shall go towards STEM education and training.	An employer would pay a \$1,000 fee with each labor certification, which shall go towards STEM education and training.
<b>STEM Fee for H-1B and L-1 Petitions</b>	No STEM-specific fund in current law.	An employer must pay a \$2,500 fee for each H-1B or L-1 petition, which shall go towards STEM education and training. This fee is reduced to \$1,250 for employers that have 25 or fewer employees.	An employer must pay a \$2,500 fee for each H-1B or L-1 petition, which shall go towards STEM education and training. This fee is reduced to \$1,250 for employers that have 25 or fewer employees.
<b>Prohibition on H-1B/OPT Advertising</b>	Nothing in current law.	An employer must not advertise that the position is only available to H-1B workers or that an individual who is in H-1B or OPT status will be given preference in the hiring process.	No provision in bill.
<b>Disclosure of H-1B and L-1 Information</b>	Annual report regarding country or origin, occupations, educational levels, and compensation paid to H-1B workers during prior fiscal year.	The Bureau of Immigration and Labor Market Research (in USCIS) will publish a report of both H and L information, including but not limited to: <ul style="list-style-type: none"> <li>• A list of H-1B employers, the occupational classifications for the H-1B positions, and the number of H-1B workers the employer sponsors for a green card;</li> <li>• A list of all H-1B employers that are dependent, skilled-worker dependent, or subject to the 30 percent/50 percent fee;</li> <li>• Gender breakdown by occupation and country of H-1B workers;</li> </ul>	No provision in bill.

SELECT HIGH-SKILLED IMMIGRATION PROVISIONS			
Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
		<ul style="list-style-type: none"> <li>• A list of employers with more than 15 percent of workers in L-1 status; and</li> <li>• Number of H-1B workers categorized by highest level of education.</li> </ul> <p>The Bureau will survey employers on good faith recruitment and report on best practices and recommendations for recruiting steps that employers can take to maximize hiring American workers.</p>	
<b>State Workforce Agency</b>	Nothing in current law for H-1Bs. For green card sponsorship where Labor Certification is required, posting required on individual website of the state workforce agency of state where job site located.	For all H-1B positions (for which 30 day posting required on new DOL website), the Secretary of Labor shall facilitate the posting of the job on the internet website of the state labor or workforce agency where the position will be located.	For green card sponsorship where Labor Certification required, the Secretary of Labor shall facilitate the existing required posting at the state workforce agency on a single searchable DOL website.

TECHNICAL AMENDMENTS			
<b>Dependent Employer Calculation</b>	For purposes of identifying when H-1B dependent, exemptions for any H-1B with Masters or paid greater than \$60,000 (which includes a high percentage of H-1B workers).	When calculating H-1B or L-1 dependency, or whether an employer is subject to additional H-1B or L-1 fees, universities are excluded and foreign workers who are in the green card process (“intending immigrants”) are excluded from the calculation. However, an employer must file immigrant petitions for at least 90 percent of the workers who are the beneficiaries of approved DOL labor certifications. No exemptions based on salary or education level.	No change to definition of dependent employer.



**SELECT HIGH-SKILLED IMMIGRATION PROVISIONS**

Provision	Current Law	Senate Bill - S.744	SKILLS Visa Act H.R. 2131 (introduced)
<b>H-1B Skilled Worker Dependent</b>	Concept of “H-1B Skilled Worker Dependent” is not in current law.	<p>More than 15 percent of total US workers who are in Job Zone 4 or 5 (O*NET) are in H-1B status. Employer may exclude intending immigrants (see above) and universities are excluded altogether.</p> <p>Job Zone 4 (considerable preparation needed): most occupations require a bachelor’s degree, with some exceptions. Position usually requires several years of experience. Examples include: accountants, sales managers, database administrators, teachers, chemists, and environmental engineers.</p> <p>Job Zone 5 (extensive preparation needed): most occupations require graduate degree or college degree and over 5 years experience . Examples include: librarians, lawyers, aerospace engineers, school psychologists, treasurers, and controllers.</p>	No change to definition of dependent employer.
<b>US Workforce Calculation</b>	Currently only applies to H-1B dependency.	Current law on H-1B dependency is applied to all related calculations: When calculating the total number of workers in the United States, all employees in any group treated as a single employer under section 414 of the Internal Revenue Code shall be counted.	No change to definition of dependent employer.
<b>Effective Date</b>		Clarifies that the new attestations and obligation regarding recruitment and non- displacement only apply to new hires and not existing employees.	New few obligations apply to labor condition applications and petitions filed after effective date, to workers issued visas or otherwise provided status after the effective date.



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# Abbreviations and About the Authors





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## ABBREVIATIONS

<b>AAR</b>	–	Authority for Advance Ruling
<b>ALP</b>	–	Arm’s Length Price
<b>AMP</b>	–	Advertising, Marketing and Promotions
<b>AO</b>	–	Assessing Officer
<b>APA</b>	–	Advance Pricing Agreement
<b>BC</b>	–	Business Connection
<b>BEPS</b>	–	Base Erosion and Profit Shifting
<b>BLS</b>	–	Bureau of Labor Statistics
<b>BPO</b>	–	Business Process Outsourcing
<b>BRIC</b>	–	Brazil, Russia, India and China
<b>CA</b>	–	Competent Authority
<b>CBDT</b>	–	Central Board for Direct Taxes
<b>CFC</b>	–	Controlled Foreign Company
<b>CIT (A)</b>	–	Commissioner of Income Tax (Appeals)
<b>CPM</b>	–	Cost Plus Method
<b>DE</b>	–	Dependent Employer
<b>DHS</b>	–	Department of Homeland Security
<b>DIT</b>	–	Directorate of Income Tax
<b>DOL</b>	–	Department of Labor
<b>DRP</b>	–	Dispute Resolution Panel
<b>DTAA</b>	–	Double Taxation Avoidance Agreement
<b>DTC</b>	–	Direct Tax Code
<b>FDI</b>	–	Foreign Direct Investment
<b>FII</b>	–	Foreign Institutional Investment
<b>FTS</b>	–	Fee for Technical Services
<b>G20</b>	–	Group of 20



<b>GAAR</b>	–	General Anti-Avoidance Rules
<b>GAO</b>	–	Government Accountability Office
<b>GATS</b>	–	General Agreement on Trade in Services
<b>GDP</b>	–	Gross Domestic Product
<b>GoI</b>	–	Government of India
<b>GOP</b>	–	Grand Old Party (Republican)
<b>GST</b>	–	Goods and Services Tax
<b>HMRC</b>	–	Her Majesty’s Revenue and Customs
<b>IT</b>	–	Information Technology
<b>IT</b>	–	Information Technology
<b>ITAT</b>	–	Income Tax Appellate Tribunal
<b>ITD</b>	–	Income Tax Department
<b>ITeS</b>	–	Information Technology-enabled Services
<b>KPO</b>	–	Knowledge Processing Outsourcing
<b>LCA</b>	–	Labor Condition Application
<b>LO</b>	–	Liaison Office
<b>LoB</b>	–	Limitation of Benefits
<b>MAM</b>	–	Most Appropriate Method
<b>MAP</b>	–	Mutual Agreement Procedure
<b>MNEs</b>	–	Multi National Enterprises
<b>OECD</b>	–	Organisation for Economic Co-operation and Development
<b>OPT</b>	–	Optional Practical Training
<b>PE</b>	–	Permanent Establishment
<b>PERM</b>	–	Program Electronic Review Management
<b>R&amp;D</b>	–	Research and Development
<b>R&amp;D</b>	–	Research and Development
<b>SAAR</b>	–	Special Anti-Avoidance Rules
<b>STEM</b>	–	Science, Technology, Engineering and Mathematics
<b>SWDE</b>	–	Skilled Worker Dependent Employer
<b>TNMM</b>	–	Transactional Net Margin Method
<b>TP</b>	–	Transfer Pricing
<b>TRC</b>	–	Tax Residency Certificate
<b>UN</b>	–	United Nations
<b>USCIS</b>	–	United States Citizenship and Immigration Services
<b>USIBC</b>	–	United States-India Business Council
<b>WTO</b>	–	World Trade Organization

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