Indian tax administration issues revised circulars on transfer pricing issues relating to development centers

Executive summary

This tax alert provides a summary of revised Circulars issued by the Apex Indian tax administrative authority, the Central Board of Direct Taxes (Board) on transfer pricing issues relating to development centers. The Board had earlier issued circulars on 26 March 2013 on conditions for identifying development centers engaged as contract research and development (R&D) service providers with insignificant risk (Circular 3) and on application of the profit split method (PSM) (Circular 2) in the case of R&D activities.

In light of the representations received from various stakeholders regarding the two circulars, the Board has reviewed the earlier circulars and has now issued revised circulars. Circular No 5/ 2013 (Circular 5), dated 29 June 2013, rescinds Circular 2. Circular No 6/ 2013 (Circular 6), dated 29 June 2013, amends conditions listed in Circular 3 for a development center to qualify as a contract R&D center with insignificant risks. The amendments, while retaining the substance of Circular 3 conditions, appear to provide a relatively greater degree of operational latitude and flexibility to qualify inter-company arrangements as providing contract R&D services. The withdrawal of Circular 2 should help in avoiding a presumption that may have been created that PSM may be the preferred method for arrangements that do not satisfy the conditions for contract R&D with insignificant risks.

Background

Transfer pricing issues relating to R&D centers have created a fair bit of controversy in the Indian context and a number of such issues are currently under litigation at various appellate levels. Generally, the Indian affiliates providing services operate as “contract service providers” and are insulated from business risks by their foreign
affiliate and hence remunerated by way of a routine return on costs for the functions performed. The Indian tax authority has been proposing significantly higher returns, which could either be through higher mark-ups or by allocating additional location savings or some part of the returns relating to the intangible property (IP) of the Indian affiliate. In view of the above controversy and having regard to the concerns expressed by various stakeholders, the Government of India formed a Committee under the Chairmanship of Mr. N. Rangachary to review the taxation of development centers. Based on the recommendations of the Committee, the Board issued Circulars 2 and 3 with the stated intention to provide certainty to taxpayers on issues relating to transfer pricing of development centers.4

Subsequent to the issue of the two circulars, the Board received representations from various stakeholders on the contents of the circulars. It has been represented that there is a need for providing more clarity on the principles for distinguishing and appropriately characterizing R&D centers and identifying the most appropriate method for determining the arm's length price/transfer pricing. The matter has been reviewed in light of the representations received, and accordingly Circulars 5 and 6 have been issued by the Board.5

Circular 6 on amendment to conditions relevant for identifying development centers engaged in contract R&D services with insignificant risks

According to Circular 6, R&D Centers set up by foreign companies can be classified into three broad categories based on functions, assets and risk assumed by the center established in India. These are - (1) Centers that are “entrepreneurial” in nature, where the development center performs significantly important functions and assumes substantial risks; (2) Centers that undertake “contract research and development” where functions, assets and risks are minimal; and (3) Centers that are based on “cost-sharing arrangements” and fall between the first and the second case above.

The Circular further states that more often than not, taxpayers claim that the Development Center in India must be treated as a contract R&D service provider with insignificant risk and consequently the taxpayers assert that the Transactional Net Margin Method (TNMM) must be applied as the most appropriate method. The Circular lays down the following guidelines for identifying a Development Center as a contract R&D service provider with insignificant risk:

- Foreign principal performs most of the economically significant functions involved in research or product development cycle either through its own employees or through its associated enterprises (AEs) while the Indian Development Center carries out the work assigned to it by the foreign principal. Economically significant functions would include critical functions such as conceptualization and design of the product and providing the strategic direction and framework;

- The foreign principal or its AEs provide funds / capital and other economically significant assets including intangibles for research or product development. The foreign principal or its AEs also provide remuneration to the Indian Development Center for the work carried out by the latter;

- The Indian Development Center works under the direct supervision of the foreign principal or its AEs which have not only the capability to control or supervise but also actually control or supervise research or product development through its strategic decisions to perform core functions as well as monitor activities on a regular basis;

- The Indian Development Center does not assume or has no economically significant realized risks. If a contract shows that the foreign principal is obligated
to control the risk but the conduct shows that the Indian Development Center is doing so, then the contractual terms are not the final determinant of actual activities;

- In the case of a foreign principal being located in a country/territory widely perceived as a low or no tax jurisdiction, it will be presumed that the foreign principal is not controlling the risk. However, the Indian Development Center may rebut this presumption to the satisfaction of the revenue authorities. Low tax jurisdiction shall mean any country or territory notified in this behalf under section 94A of the Income-tax Act, 1961 (ITL) or any other country or territory that may be notified for the purpose of Chapter X of the ITL;

- Indian Development Center has no ownership right (legal or economic) on the outcome of the research, which vests with the foreign principal, and that this is evident from the contract as well as from the conduct of the parties.

The Circular states that the tax authorities shall determine the appropriate characterization of the development center and the choice of the “most appropriate method” shall be done having regard to the guidelines above, the ITL provisions and the Rules made there under. It also states that the tax authorities will be guided by the conduct of the parties and not merely by the terms of the contract.

Circular 5 rescinding Circular 2 on application of PSM

The ITL provides that the arm’s length price in relation to an international transaction / specified domestic transaction shall be determined having regard to the “most appropriate method.” The Rules also provide for factors that need to be considered for determining the most appropriate method. The Board is of the view that Circular 2 created an impression that PSM was the preferred method for the transactions involving transfer of unique intangibles or in multiple interrelated international transactions. Accordingly, in order to remove the ambiguity created by the aforesaid Circular, the Board has now withdrawn the same with immediate effect.

Comparative analysis between Circular 3 and Circular 6

The conditions listed in Circular 3 were generally considered to be very prescriptive. Further, by making the prescribed conditions cumulative, the Circular offered limited operational latitude for qualifying an arrangement as contract R&D. This could have resulted in subjective application of the Circular as well as in unintended consequences where an R&D arrangement substantively, but not completely, complied with the prescribed conditions. It could have also created challenges in application given the diverse models that exist for undertaking R&D activities among multinational enterprises (MNEs) and as new models continue to evolve with advances in technology. A strict application of Circular 3 could have placed pressure on the fundamentals of a limited-risk contract R&D structure, which are commonly set up in India by MNEs. The revised Circular seeks to address some of these concerns. The key changes that have been made are as follows:

- The conditions prescribed in the revised Circular are not cumulative or exhaustive requirements. Instead, the conditions are to be regarded as guidelines that need to be considered having regard to the totality of facts.

- Circular 3 seemed to imply that the foreign principal should physically perform all the economically significant functions relating to R&D and provide the necessary capital / funding and assets to the Indian R&D center. The revised Circular clarifies that such functions may be performed by the foreign principal or its AEs. The revised Circular also clarifies that economically significant functions include taking strategic decisions in relation to R&D.

- Circular 3 also seemed to suggest that the Indian Development Center should largely perform economically less significant functions. The revised Circular substitutes this condition with the requirement that the Indian Development Center should carry out work assigned to it by the foreign principal.
The revised Circular retains the condition contained in Circular 3 on the rebuttable presumption regarding control over risks in case the foreign principal is located in a jurisdiction perceived to be a no or low tax jurisdiction. However, the Circular now specifies that a low tax jurisdiction would be one that is notified by the Government. As of now, no such country or territory has been notified.

The revised Circular broadly retains the requirement that the foreign principal (or its AEs) should perform the core functions, has the necessary “control functions” and actually controls and supervises the R&D activity of the Indian affiliate by undertaking strategic decisions. The revised Circular also reiterates that satisfaction of the conditions would be evaluated based on actual conduct of the parties and not just the contractual terms.

Our Comments

Circulars issued by the Board for purpose of proper administration of a tax statute could be in the nature of contemporanea exposition (i.e., exposition by a contemporary authority) furnishing aid in the construction of a provision. Judicial decisions in the legal nature of Circulars in the past have held that in the exercise of its powers to issue general circulars, the tax administration may not impose a burden on the taxpayer or otherwise put him in a worse position than he is under the statute. But the administration can relax the rigor of the law or grant relief that is not found in the terms of the statute. Taxpayers may therefore need to consider the legal effect of the Circular for their facts, having regard to these principles.

The revised circulars provide a relatively greater degree of operational latitude and flexibility to qualify inter-company arrangements as the provision of contract R&D services. The withdrawal of Circular 2 should help in avoiding a presumption that may have been created that PSM may be the preferred method for arrangements that do not satisfy the conditions for contract R&D with insignificant risks. A Board press release dated 29 June 2013 also states that “Safe Harbour rules” are under consideration and will be issued shortly. These rules are expected to provide certainty for transfer pricing issues relating to development centers that are engaged in providing contract R&D services.

Nonetheless, having regard to the current enforcement environment and legislative and administrative developments, it becomes important for taxpayers to develop or enhance their documentation. The revised Circular continues to emphasize the importance of “risk control functions” as an approach to analyzing and documenting the functional analysis. It is therefore of critical importance to identify the functional ownership of risks and assets. This would ensure that taxpayer’s analysis of the “risk control functions,” having regard to the managerial or operational control exercised over the risks, is properly analyzed and documented. This approach may better support the risk control analysis framework that the Circular expects a taxpayer to present.

Taxpayers may therefore need to consider undertaking an impact assessment of the revised Circulars on their transfer pricing arrangements. Taxpayers should also consider a more proactive approach to controversy management and dispute resolution early in the lifecycle of an audit. In addition to relying on domestic tax law appeal and litigation, taxpayers could consider use of the advance pricing agreement mechanism and treaty-based competent authority proceedings.

Endnotes

4. Refer footnote 3 above.
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