CBDT Circulars on Transfer Pricing of Contract R&D Centres: More Questions than Answers?

Characterization of development centers of multinational companies ('MNC') in India has been a vexed issue for a considerable time. While the MNCs contend that they are contract R&D service providers bearing insignificant or risk-free entities, the Transfer Pricing Officers ('TPO's') have been treating them as full or significant risk bearing entities – thus, attributing a higher mark-up for the functional and risk profile borne by them. Given the possibility of the issue of snowballing into a large-scale controversy, the Prime Minister in July 2012 announced the setting-up of Rangachary Committee to review the taxability of development centres. Based on the report of the Committee, the CBDT on March 26, 2013, issued Circulars No. 2 and 3, which seek to provide guidance on the application of Profit Split Method and conditions to identify development centres with insignificant risk respectively. Let us follow the perspective of the author who analyses the CBDT circulars on transfer pricing…

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Profit, the single most buzzword, drives the majority of the industry mandarins. For centuries, businessmen and business houses have aimed towards maximizing the profits of their operations. In the early days of zero or negligible competition, this was achieved by fixing higher prices. As competition begun to increase, margins came under pressure and consequently, businesses started to look outwards towards greener pastures. This cross-border trade sowed the initial seeds of today's globalization.

First movers of the cross-border trades reaped huge profits leading many others to follow suit. However, the economic pressures of various countries and increased competition brought a second wave of stressed-out margins. Due to the increasing economic strength of developed nations and the rising cost of living of

their population, the cost of production spiraled in the developed countries and therefore, the cost of products became unviable or margins became thin. Resultantly, many multinational companies moved their production facilities or outsourced the production to under-developed or developing countries where the cost of production was still low compared to developed countries. Typically, as the goods were contract manufactured from entities in developing/ underdeveloped countries, the manufacturer was paid a nominal cost-plus mark-up for the functions performed by it and the low cost of production ensured that the goods retained their competitive edge.

Now, it is a given fact that, in today's highly competitive business environment where consumer is the king, it is necessary that business continuously searches options that lower their cost in order to increase their profit yet retain their competitive edge. In this context, the concept of location savings, i.e. moving certain operations to low-cost jurisdictions (like India) has gained prominence.

Globally, India along with a handful of other developing countries are considered to be an ideal location to avail benefit of location savings due to various advantages like huge pool of skilled yet relatively cheaper workforce, availability of raw materials at competitive rates, cheap infrastructure cost, various tax incentives, etc. India with its booming economy at the turn of the millennium, however, became first among equals.

The initial thought process of various multinational corporations was to avail benefit of the above factors to roll out products at cheap rate. However, multinational companies, especially the software and pharmaceutical majors realized soon that with a huge and young talent pool, even the high value-added services and innovation services could be moved to India. These multinational companies devote huge resources, both in terms of capital as well as manpower to innovate and create better or unique products. Due to higher cost of manpower in developed countries, more and more multinational companies have established captive subsidiaries in India for carrying out product development, software development, performing analytical work, etc.

Typically, the Indian subsidiaries have been positioned as providing routine services and do not employ valuable assets nor bear any significant risks. Resultantly, the Indian subsidiaries have been remunerated using traditional transfer pricing methodology like Cost-Plus Margin ('CPM') Method or Transaction Net Margin Method ('TNMM') so as to ensure that the Indian subsidiary earns a margin on its total costs which is commensurate with that earned by comparable uncontrolled service providers. In this kind of an arrangement, the foreign associated enterprise ('AE'), in most cases the parent company, earns the returns related to intangibles created as well as the benefit of location savings, if any.

The initial round of dispute between the taxpayers and the Indian transfer pricing authorities mainly centered on the level of margins that the captive subsidiaries should earn. For example, the Indian subsidiary engaged in contract R&D may be remunerated at let's say cost plus 18-20%; conversely, the view of the transfer pricing authorities was that the Indian subsidiary should be remunerated at let's say cost plus 30-35%. The mark-up varied depending upon the final list of comparable companies.

However, the controversy has now assumed larger proportions with the transfer pricing authorities contending that the captive subsidiaries/development centers are not rendering routine services but are involved in providing high-level end-to-end services leading to creation of intangibles. Accordingly, it is the contention of the transfer pricing authorities that the Indian subsidiaries should be remunerated for the intangibles which gets created by it.

Detailed discussion on the same can also be found from the India Chapter of the United Nations Practice Manual on transfer pricing issues for developing countries ('UN TP Manual').

India Chapter of UN TP Manual

Paragraphs 10.3.8.8 to 10.3.8.11 of the India Chapter of the UN TP Manual contains the observations of the Indian transfer pricing authorities on the vexed issue of characterization of the captive subsidiaries engaged in providing contract R&D services. The report mentions that typically the parent or the overseas group company positions the Indian subsidiary as a risk-free or limited risk bearing entity and hence, try to justify the low margins of the Indian subsidiary. Correspondingly, the overseas AE is positioned as the entity controlling all the risk and hence, entitled to a major part of the profit accruing as a result of the R&D activities.

The above arguments have been countered by the Indian transfer pricing authorities by stating that based on the detailed functional analysis conducted in course of the transfer pricing assessments, the Indian subsidiaries were found to be bearing significant risk. Further, these subsidiaries undertook detailed strategic decisions, monitoring of the R&D activity and employed substantial assets to conduct the R&D activity. Then the activities of R&D center resulted in creation of unique intangibles whose legal ownership was transferred to the parent company under the contract R&D arrangement. Given the same, the routine cost plus compensation model does not meet the arm's length criteria and additional compensation for development and transfer of such intangibles needs to be given to the Indian subsidiaries.

The contentions made by the taxpayer for characterization of Indian subsidiaries as low-risk contract R&D service provider and the counter claims of the Indian transfer pricing authorities is summarized:

Criterion	Argument of Taxpayers	Argument of Transfer Pricing Authorities
Functions	The parent company designs and monitors all the research programs of the subsidiary	Most multinational companies were unable to justify this claim by filing relevant supporting documents
Funding	Funds for undertaking the R&D program were provided by the parent company	While there is no dispute that funds were provided by parent company and hence, it bears risks related to it, the Indian subsidiary employs various assets like skilled manpower, knowhow for R&D etc. Hence, the Indian subsidiary too bears risk
Budgeting	The parent company prepares, controls and manages the annual budget of the subsidiary for R&D activities	The Indian management decides to allocate budget between different streams of R&D activities. Further, the day to day performance is anyways managed by the Indian management
Strategic decisions	The parent company controls and undertakes all the strategic decisions with regard to core functions of the R&D activity	The Indian subsidiary undertook day to day strategic decisions and monitored the R&D activities. Thus, it bore the operational risk
Risk of unsuccessful R&D activity	The parent company bore the risk of unsuccessful R&D activity	--

A reading of the arguments presented by the Indian transfer pricing authorities suggest that they do not accept the notion that the risk can be controlled remotely by the parent company and the Indian subsidiaries engaged in the R&D activity are risk-free entities. It is the contention of the Indian transfer pricing authorities that as the function of R&D activity is undertaken by the Indian subsidiary, therefore, the important strategic decisions relating to the same would also be undertaken by the management and employees of the Indian subsidiaries. Accordingly, the Indian subsidiary can be considered exercising control over the operational and other risks. Consequently, the ability of the parent company to remotely control the risk from a place where the core functions of R&D are not located is very limited. Hence, it is the Indian subsidiary and not the overseas parent company that assumes the substantial part of the risk, and, hence, should be remunerated accordingly.

Constitution of Rangachary Committee to Review

This divergent view relating to characterization of development centers as low-risk Contract R&D centers or full-fledged risk-bearing R&D service provider has resulted in quite a few high profile adjustments for Multinational companies. Given the prospect of the issue to snowball into huge controversy, the Prime Minister set-up a committee under the aegis of former CBDT Chairman Shri N. Rangachary to look into the issue and suggest the approach to taxation of Development centers. The Rangachary Committee submitted its report on September 14, 2012.

Though, the content of the report has not been released to various stakeholders for consultation, as a follow-up to the constitution of the committee, the CBDT on March 26, 2013, has issued Circular 3/2013 which lays down the conditions relevant to identify development centers engaged in contract R&D services with insignificant risk. Further, Circular 2/2013 deals with application of Profit Split Method ('PSM'), which determines an appropriate return of intangibles on the basis of relative contributions made by each associated enterprise.

Circular 3/2013: Identifying Development Centers with Insignificant Risks

The Circular states that an R&D development centre in India will be characterized as a contract R&D service provider bearing insignificant risks only if the following conditions are cumulatively complied with:

1. *Economically Significant Functions:* The foreign principal performs most of the economically significant functions in the R&D cycle while the Indian affiliate largely performs economically insignificant functions.
2. *Economically Significant Assets:* The principal provides funds/capital and other economically

significant assets including intangible assets to the Indian affiliate for R&D. The Indian affiliate does not use any other economically significant assets in its R&D activity.

3. *Control and Supervision:* The foreign principal performs 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 Indian affiliate works under the direct supervision of foreign principal.
4. *Economically Significant Risk:* The Indian affiliate does not assume or bear any economically significant risks. Contractual terms will not be recognized if the terms are not consistent with the conduct of the parties. However, the circular has incorporated a deeming fiction to state that where the foreign principal is located in a low or no tax jurisdiction, it will be presumed that the foreign principal is not controlling the risks unless the Indian affiliate can rebut this presumption with appropriate facts before the tax authorities.
5. *Legal or Economic Ownership:* The foreign principal would be the legal and economic owner of the outcome of the research and the Indian affiliate would have no ownership rights on the same.

Further, the Circular states that the satisfaction of the above conditions will be determined primarily by analyzing the conduct of the parties and not merely by the contractual terms.

Going on by the flavor of the Circular, it seems that the CBDT has laid its emphasis on *substance over form* at the level of the foreign parent, as a pre-condition for the Indian R&D centre being accorded a *contract R&D service provider* status. The said is consistent with the views expressed in the Discussion Draft on transfer pricing aspects of intangible property issued by the Organisation for Economic Cooperation and Development ('OECD') in 2012. The draft lays down that while the contractual obligations between the two parties may be considered as a starting point for assessing which entity should be entitled to the returns on the intangible, the ultimate deciding factor should be considered to be the actual conduct between the parties. As per the OECD guidelines too, the entity which stakes its claim to the returns on the intangibles should demonstrate performance of the functions, assumption of risks and utilization of assets for undertaking the R&D activity.

Issuing a circular definitely shows the intent of the legislature to resolve the dispute. However, lot of clarity is required while identifying whether an Indian entity is an independent R&D unit or a contract R&D unit. There could be potential issues on interpretation of certain points like what shall be economically significant functions, who shall be covered under the definition of Principal i.e. whether the entity with whom service arrangement is made or group as a whole, how would one demonstrate performance of core functions i.e. what shall be the parameters, etc which needs clarity. Further, the conditions prescribed under the circular offers very little allowance for consideration of unique facts/ circumstances for qualifying an arrangement as that of a pure contract R&D. Accordingly, it would be advisable that the taxpayers are provided greater flexibility in getting their development centers qualified as contract R&D centers.

Additionally, the Circular does not specify the approach to be followed for benchmarking the transactions once the Indian subsidiary has been characterized as a low risk contract R&D service provider. Clarity on the approach to be followed in such a situation would definitely clear a lot of confusion and potential litigation for various entities qualifying as low risk contract R&D service providers.

Circular 2/2013: Application of PSM

The Circular seeks to provide clarification on use of PSM as the most appropriate method in the context of transfer pricing for R&D centres. The Circular mentions that In the absence of a correlation between the cost of the R&D activities and the return on the intangible developed through the R&D activity, the use of TNMM that seeks to estimate the value of the intangible based on a cost plus model, is discouraged; the circular encourages use of PSM in such cases.

The Circular notes that as per Rule 10B(1)(d) of the Income-tax Rules, 1962 ('Rules'), PSM can be applied in international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for determining the arm's length price on a standalone basis. In such a scenario, PSM which determines the appropriate return on intangibles on the basis of relative contributions made by each AEs would be a better method.

The reiteration of the Circular 2/2013 that PSM would be the most appropriate method to benchmark the transactions involving transfer of unique intangibles and issuance of this Circular along with Circular 3/2013 on Development Centers, seems to suggest that the revenue authorities are seeking to apply PSM as the most appropriate method in case of transactions involving R&D services through the contract R&D service providers where such R&D service providers or the Development Centers do not qualify as contract R&D service providers bearing insignificant risk as specified under the Circular 3/2013. However, the Circular has not clarified in certain terms the approach to be adopted in case of Development Centers which qualify as contract R&D service providers bearing insignificant risks.

Here, it needs to be noted that selection of PSM as the most appropriate method would inter alia depend upon

the following factors as specified in Rule 10C(2) of the Rules:

1. Nature and class of international transactions
2. Nature of AEs entering into transactions and the functions performed, assets utilized and the risks assumed by them
3. Availability, reliability and comprehensiveness of the data required for application of the method
4. Degree of comparability between the international transaction and uncontrolled transactions and with the companies adopted as comparable to the tested party
5. Ability and extent to which reliable and accurate adjustments could be made for the differences between the international transactions and comparable uncontrolled transactions
6. Nature, extent and reliability of assumptions required to be made in application of the method.

Given the various factors which affect the selection of PSM as the most appropriate method, even if theoretically it may result in being the most appropriate method, application of the same may not be always possible. Accordingly, determination and application of the most appropriate method would need to be analyzed on case to case basis.

The Circular seems to have recognized this practical challenge and indirectly, provided flexibility to the transfer pricing officers that where PSM cannot be applied due to non-availability of information and reliable data, he may consider other methods like TNMM or comparable uncontrolled price ('CUP') method after giving reasons for non-applicability of PSM. Upon documenting such reasons, other methods may be applied by selecting comparables engaged in IP development in the same line of business and by making appropriate adjustments for value of IP transferred, location savings, etc.

However, the Circular has also reiterated that the onus of maintaining the requisite documentation for application of PSM is on the taxpayer (Rule 10D of the Rules). Accordingly, there should be good and sufficient reasons for the non-availability of such information with the taxpayer. Accordingly, taxpayers would be well advised to ensure that PSM may not be summarily rejected citing lack of data but adequate and convincing reasons may be documented by the taxpayer in support of non-availability of specific information which led to rejection of PSM as the most appropriate method.

Thus, the Circular certainly provides an insight to the thought process of the revenue authorities on the issue of transfer pricing of R&D service providers who do not qualify as the contract R&D service providers bearing insignificant risk. However, it is silent on the approach to be adopted on those contract R&D service providers who qualify as low risk bearing service providers as per the Circular 3/2013. The authorities would be well advised to provide clarity on the same so that scope of litigation related to the same could be avoided.

Concluding Thoughts

Overall, it appears to be a very welcome move on the part of the CBDT in proactively introducing guidelines and clarifications in the form of the above circulars. However, it is uncertain as to how the tax authorities would interpret and apply these circulars during the TP audits.

Though, the Circular 2/2013 provides for the application of PSM, it is essential to note that the CBDT has just reiterated the principles provided in the Rules and no new guidance has been provided. Further, the rejection of TNMM or other methods for transactions involving transfer of intangibles has been based on the premise that there is no correlation between costs incurred on R&D activities and return on an intangible developed through such R&D activities. Thus, while the Circular has sought to clarify the position on application of PSM, the ambiguity has not been adequately dealt with.

Further, as regards the Circular 3/2013 is concerned, it now appears to introduce the concept of substance while determining risk allocation. Thus, the focus of the transfer pricing authorities now seems to be 'substance over form' and it would be prerogative to demonstrate that the arrangement for undertaking the contract R&D services should have some justifiable business or commercial purpose. Accordingly, the transfer pricing authorities are now more likely to check the actual facts of the arrangement rather than go simply by the contractual terms. For example, where the Indian subsidiary is engaged in providing contract R&D services to its overseas AEs which has no R&D setup itself and therefore, in effect the complete R&D process is undertaken by Indian subsidiary itself, the transfer pricing authorities may not accept that the Indian subsidiary is a low or insignificant risk bearing entity doing only low-end contract R&D.

Given the fact that both the circulars have cast the onus of justifying the commercial arrangement and the methodology of undertaking transfer pricing analysis of the contract R&D service on the taxpayers, the taxpayers would be well-advised to undertake a detailed FAR analysis of the international transactions based on the actual functions performed, risks assumed and the assets employed and document its findings in support of its transfer price rather than rely on the contractual provisions alone.

Given the fact that taxpayers are already facing litigation on the issue, taxpayers would be advised to proactively consider the impact of these circulars on their transfer pricing arrangements and seek to adopt ways and means to mitigate litigation including obtaining ruling under the Advance Pricing Agreements route and treaty-based competent authority proceedings. ■