CBDT Circulars 5 & 6— Is It Sufficient?

In March 2013, the Central Board of Direct Taxes (CBDT) had issued two circulars—Circular 3/2013 clarifying the conditions for a R&D arrangement to qualify as contract R&D with insignificant risk, and Circular 2/2013 on the application of Profit Split Method. The Circulars intended to provide greater clarity and certainty to Development Centres in India facing the challenge of transfer pricing. However, these circulars created greater apprehensions given their ambiguous text. Based on representations received from key stakeholders, the CBDT has issued fresh circulars—5/2013 & 6/2013 on 29th June 2013. These circulars address some of the concerns of taxpayers but still leave some questions unanswered. Read on to know more…

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Transfer Pricing of development centres (DCs) in India has been an area of significant dispute between taxpayers and the tax administration. The battle hinges on two core questions. Firstly, how should the Indian DC be characterised on the basis of its activity profile, risks and assets? Thereafter, considering the characterisation, what is an appropriate transfer pricing methodology to arrive at fair remuneration to the DC for its efforts?

Eight rounds of transfer pricing assessments in India have resulted in massive adjustments for a variety of taxpayers. The IT/IT-enabled/Pharma industry

has borne the brunt of these adjustments. The tax administration believes that Multinational Enterprises set up captive DCs in India and benefit from lower costs and an easily accessible talent pool. According to them, these DCs perform significant value adding functions and bear key risks, create or own intangibles which are not adequately compensated. Transfer Pricing adjustments to attribute a larger share of profits to Indian DCs are, therefore, warranted. On the other hand, taxpayers, while acknowledging the reasons for outsourcing, point out the mistaken belief that critical functions, risks and assets vest with the DC. They argue that DCs perform routine functions, do not bear any risks and do not own material tangible or intangible assets. Hence, an assured return to the DC reflects the arm's length principles.

Realising the severity of this issue, the Prime Minister had set up the Rangachary Committee to examine taxation of DCs and recommend changes. As a follow-up step, the CBDT issued Circulars 2/2013 (Circular 2) & Circular 3/2013 (Circular 3), in March to provide guidance. Although the stated intent of these circulars was to provide clarity on how a DC would be characterised and the TP method best suited for them, they belied these expectations. The circulars were received with apprehension and skepticism. They did not provide definite guidance, were seen to be open ended and prone to misuse by the tax authorities.

Taxpayers and tax practitioners felt that Circular 3 prescribed a set of very rigid conditions for a DC to qualify as providing contract R&D services with insignificant risk. It required taxpayers to fulfill these conditions cumulatively. Furthermore, it did not explain certain terms like 'economically significant', 'low tax jurisdiction' and placed a very high burden of proof on taxpayers. Most importantly, the Circular did not state what the TP method would be in case a DC in India did fulfill the conditions and was found to be providing contract R&D services with insignificant risks.

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The Indian Income-tax Act, 1961 ("Act") and the Indian Income Tax Rules, 1962 ("Rules") together provide that the arm's length price of an international transaction (or Specified Domestic Transaction) should be evaluated using the 'most appropriate method'. The Indian regulations do not prescribe any hierarchy of methods and require the analysis to be undertaken based on facts and the comparability factors provided therein. Circular 2, while describing the applicability of the Profit Split Method, created an impression that it was the preferred method for transactions involving intangibles. This appeared to violate the original legislative intent. The circular also directed the tax authorities to use the Transactional Net Margin Method (TNMM) or the Comparable Uncontrolled Price Method (CUP method) but only after taking into account location savings and location advantages. However, there was no guidance on how these aspects were to be factored in an analysis.

The CBDT has correctly given cognisance to the discomfort created by the Circulars. It has demonstrated a cooperative spirit and has acted on the representations received from various quarters to review the earlier circulars. These efforts have cumulatively taken the form of Circular 5/2013 (Circular 5) and Circular 6/2013 (Circular 6) issued on 29th June 2013.

Circular 5

Circular 5 rescinds Circular 2 on the application of PSM. This corrects the ambiguity created by Circular 2 on PSM being a preferred method despite the regulations enshrining the use of the 'most appropriate method' with regard to facts and circumstances.

Circular 6

Circular 6 amends the conditions listed in Circular 3 and attempts to provide clearer guidance.

As per the circular, R&D centres can be classified into three broad categories based on functions, assets and risk assumed by the centre established in India. These are:

1. Centres which are **entrepreneurial** in nature—entities which assume substantial risks and perform significant functions;
2. Centres which undertake **contract** research and development—entities which have minimal functions, assets, and risk; and
3. Centres which are based on **cost-sharing** arrangements—these entities will fall somewhere in between the first and second categories above.

This classification methodology is in line with the

recommendations of the Rangachary Committee and is not a watertight compartmentalisation.

It is worthwhile to understand how Circular 6 differs from Circular 3. A comparative analysis of the conditions for an arrangement to qualify as contract R&D with insignificant risks between the two circulars is tabulated below:

The tax authorities would need to bear these conditions in mind and take a decision based on the totality of facts and circumstances. Their decision should be guided by the conduct of the parties and not merely the terms of the contract.

The revised circular is a material improvement on the earlier circular and offers greater operational

Conditions in Circular 3	Conditions in Circular 6	Implications of changes
Foreign principal performs most of the economically significant functions involved in research or product development cycle whereas India development centre would largely be involved in economically insignificant functions.	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 Centre carries out the work assigned to it by the foreign principal. Economically significant functions would include critical functions such as conceptualisation and design of the product and providing the strategic direction and framework	The revised circular explains the meaning of 'economically significant' functions. It also recognises that the Indian Development Centre would largely perform work assigned to it. This would help taxpayers to demonstrate what functions reside in India and overseas basis their respective service or product lifecycle.
The principal provides funds/capital and other economically significant assets including intangibles for research or product development and the Indian Development Centre would not use any other economically significant assets including intangibles in research or product development.	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 provides remuneration to the Indian Development Centre for the work carried out by the latter.	The revised circular recognises that the DC would be remunerated by the group companies for its R&D effort.
Indian Development Centre works under the direct supervision of foreign principal who not only has the capability to control or supervise but also actually controls or supervises research or product development through its strategic decisions to perform core functions as well as monitor activities on a regular basis.	The Indian Development Centre works under the direct supervision of the foreign principal or its AE which has not only the capability to control or supervise but also actually controls or supervises research or product development through its strategic decisions to perform core functions as well as monitor activities on a regular basis	This condition remains unchanged. Identifying the risk control function continues to remain critical.
Indian Development Centre does not assume or has no economically significant realised risks. If a contract shows the principal to be controlling the risk but conduct shows that Indian Development Centre is doing so, then the contractual terms are not the final determinant of actual activities. In the case of 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 Centre may rebut this presumption to the satisfaction of the revenue authorities.	The Indian Development Centre does not assume or has no economically significant realised risks. If a contract shows that the foreign principal is obligated to control the risk but the conduct shows that the Indian Development Centre is doing so, then the contractual terms are not the final determinant of actual activities.	This condition remains unchanged. It is important for the actual conduct to be consisted with contractual risk allocation.

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	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 Centre 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 or any other country or territory that may be notified for the purpose of Chapter X of the Act.	In the revised circular, this condition instead of being a part of the earlier condition (as in Circular 3) has been identified separately. The revised circular also elaborates on what is low/no tax jurisdiction. No country/ territory has been notified as yet.
Indian Development Centre has no ownership right (legal or economic) on outcome of research which vests with foreign principal, and that it shall be evident from conduct of the parties.	Indian Development Centre 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.	This condition while largely retaining the text of the earlier circular includes the need to look at both conduct and contractual obligations while determining ownership rights on the outcome of research.

flexibility for taxpayers to qualify their inter-company R&D arrangements as contract R&D with insignificant risks. Circular 6 (unlike Circular 3) prescribes the above conditions as guidelines and does not impose any cumulative/exhaustive criteria in this respect. It also recognises that the functions and risks could be dispersed within a multinational enterprise. In defining the DC's functional profile, Circular 6 requires it to carry out the work assigned by the foreign principal instead of economically less significant functions which required subjective analysis. The revised circular introduces a level of objectivity by defining terms like economically significant functions and low tax jurisdiction.

Unanswered Questions

While the revised circular is a welcome move, it fails to address some questions. What would be the most appropriate method in case a taxpayer fulfills the conditions set out in Circular 6? In this context, it is pertinent to note the Rangachary Committee's First Report to review taxation of Development Centres and the IT Sector on page 21 states, *"The Committee recommends that if the activities carried on by a DC in India meets the following parameters (cumulatively), it will be treated as Contract R&D service provider with insignificant risk and TNMM supported by appropriate cost plus mark-up may be the most appropriate method for arriving at the arm's length price for the services rendered by such DC."* Hence, the CBDT had a wonderful opportunity to set the debate on this issue at rest by explicitly stating that TNMM would be the most appropriate method if the conditions prescribed in Circular 6 are met by a taxpayer in India. However, by not doing so, the impact of the circular has been diluted. Considering that the Expert Committee also endorsed the use of TNMM, the Government would have done well by accepting its observations.

In a sense, the circular only reiterates what DCs in India all along believed their profile was but have been left wanting on the TP method applicable to them. The circular lays emphasis on actual conduct in addition to contractual terms but does not define how this would be reconciled. To that extent, taxpayers are left bearing the burden of proof and would have to demonstrate this aspect to the satisfaction of the tax authorities.

Next Steps for Taxpayers

Transfer Pricing for DCs is expected to continue as a contentious issue. One will have to wait and watch how the circulars are given effect to by the Transfer Pricing Officers in an assessment. Meanwhile, it would be prudent for taxpayers to undertake the following:

1. Analyse the value chain and identify the key value driving functions, risks and assets and evaluate how these are distributed between the Indian DC and the group companies
2. Assess what are the risks entailed in the supply chain and how these are controlled
3. Put in place descriptive inter-company agreements clearly establishing the functional, asset and risk distribution among the parties
4. Build robust documentation explaining how the actual conduct of parties is consistent with agreed contractual terms
5. Maintain supporting documents to further supplement its positions

The above process should help taxpayers to present a well-founded defence in the event of any challenge by the tax authorities. If done, proactively, it will also establish a strong footprint of evidence and enable adherence to the conditions mentioned in the Circular. In case of existing conflicts, taxpayers may examine alternative controversy management tools like Advance Pricing Agreements and Competent Authority proceedings to stem the tide.

The Transfer Pricing law is constantly evolving. The Government views this as a key pressure point and is keenly interested in minimising disputes. A press release on 29th June also mentioned that safe harbour rules are under consideration and will be released soon. This, along with the revised circular should help in introducing more certainty thereby, soothing investor sentiments. At the same time, the Government should ensure that this effort is not impeded by ambiguous guidance that, instead of resolving disputes, spawns more controversy.

Conclusion

The Transfer Pricing law is constantly evolving. The Government views this as a key pressure point and is keenly interested in minimising disputes. A press release on 29th June also mentioned that safe harbour rules are under consideration and will be released soon. This, along with the revised circular should help in introducing more certainty, thereby soothing investor sentiments. At the same time, the Government should ensure that this effort is not impeded by ambiguous guidance that, instead of resolving disputes, spawns more controversy. Leaving questions unanswered may be a recipe for disaster. ■