Payment to foreign company for R&D cost allocation taxable under the Income-tax Act, 1961 and the India-Germany Tax Treaty

In brief

In a recent ruling in the case of “A” Systems¹ (the applicant), the authority for advance rulings (AAR) has held that payment received by a foreign company from an Indian company under a cost allocation agreement (CAA) representing Indian company’s share of the costs incurred towards research and development (R&D) activities is taxable as royalty under the provisions of the Income-tax Act, 1961 (the Act) and India-Germany Double Taxation Avoidance Agreement (the tax treaty).

Facts

- The applicant, a company based in Germany, is engaged in the business of executing contracts for assembly and supervision of paint shop, including supply of material and supervision of installation for various automobile companies.
- The applicant has a group of companies, including an Indian subsidiary, as its affiliates.
- The group has formulated a R&D policy, according to which all the R&D activities for the group are coordinated through the applicant. To participate in

¹ “A” Systems [AAR No. P of 2010]
the R&D, the group entities entered into an CAA, which provides that the R&D will be undertaken by any or all parties to it and that the applicant will be the administrator.

• The parties involved in the work in a similar line of business and under similar conditions, certain functions and services are made available by the individual parties. Therefore, all the parties can assume the role of service provider and the service recipient.

• The parties to the CAA are allowed a royalty-free unlimited access to the R&D results including any intellectual property rights generated. Though all parties to the CAA are joint owners of the intellectual property rights, the rights are registered in the name of the applicant.

• The entire cost of the R&D is to be shared by the parties to the CAA based on an allocation key.

• The CAA provides that the parties thereof grant to each other the right to exploit any technology developed under the CAA within their respective geographic regions.

• The title and full ownership of the products and all components thereof including all enhancements new versions and modules are to remain with all parties to the CAA.

• The products and components thereof inclusive of the ideas and expressions therein are trade secret or copyrighted products of all parties to the CAA and proprietary to it.

Questions before the AAR

The issue under consideration was whether the payment received by the applicant from the Indian subsidiary pursuant to the CAA is taxable under the provisions of the Act or the India–Germany tax treaty.

Applicant’s contentions

• Parties to the CAA become the joint owners of the product of the R&D and they had paid the contribution towards the expenses for the R&D.

• Use of the product by a party is without payment of any royalty.

• The ratio of the ruling in the case ABB Ltd\(^2\) would apply to the present case.

Revenue’s contentions

• The Indian subsidiary is merely an erection contractor and has not carried out any research. The contribution made by the Indian subsidiary for the R&D is a mere façade to repatriate income from India without paying tax.

• It is not a case of investing in the R&D but it is a case of a service provider and service receiver. Therefore, the payment made is for the service and it par takes the character of fees for technical services or royalty.

AAR ruling

• The cost allocation seems to be dependent on the rendering of services by one and the receipt of the service by the other. The cost allocation is not a clear

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ABB Ltd v. CIT in re [2010] 322 ITR 564. In the said ruling, the AAR held that the reimbursement of R&D expenses by an Indian entity to a foreign entity under a cost contribution agreement is not taxable in the hands of the foreign entity in India.
sharing of the R&D costs subject to a credit being given for the amount spent by a particular party carrying on R&D at its own expense for the benefit of all.

The CAA provides that only those costs shall be allocated which result from services rendered to the parties. Therefore, the incurring of costs depends on the receipt of services from one of the contracting parties.

• The CAA does not contain a direct provision stating that the costs are to be shared by all the participants.

• The CAA does not explain what is meant by the cost of the R&D allocation key. Though the CAA asserts that the ownership of the products shall remain with all the parties, it is not made clear on what consideration that happens.

• A party not using the product of a particular research done by a member to the CAA does not contribute towards the costs of the R&D irrespective of it not having used it. In that sense, the sharing of cost of the R&D allocation key does not have a meaning.

• In the case of ABB Ltd. relied upon by the applicant, the agreement specifically provided that the total costs for corporate R&D would be borne by the parties in proportion to the value added achieved by the parties. However, in the present case, here is no sharing of cost irrespective of the use of the product of the R&D. The payment was made only when the product or process is used. The submission that the parties to the agreement had become the joint owners of the product of the research is difficult to accept. The ratio of the ABB ruling is hence not applicable.

• The CAA is only an agreement to share the product of the R&D allegedly without payment of royalty. However, the payment of consideration has been described as the contribution towards the costs of the R&D incurred by that particular party.

• The payment occurs only on use of the product of the R&D and not otherwise. Therefore, the said payment can only be understood as a consideration for the use of the process or formula developed by the member. Hence, the payment would satisfy the definition of royalty under Explanation 2 to section 9(1)(vi) of the Act.

• The applicant is either the recipient of the consideration or a conduit through which the consideration is paid to the concerned party.

• The definition of royalty under Article 12(3) of the India – Germany tax treaty does not differ significantly from the definition in the Act as far as the use of a secret formula or process and the use of information concerning industrial, commercial or scientific experience is concerned.

• The theory of reimbursement propounded cannot stand as the payment occurs only when the process or scientific experience is used by a member. It is not a sharing of costs or reimbursement of a part of the expenses incurred for the R&D as and when it is completed. Since it is a payment for use and the payment depends solely on use, the payment can be understood only as royalty.

• The payment received by the applicant from the Indian subsidiary pursuant to the CAA representing the latter’s share of the costs incurred towards the R&D activities is royalty income both under the Act and the India – Germany Tax Treaty.

**Conclusion**

This ruling re-emphasises the importance of drafting the cost contribution agreements with appropriate care. The terms of the cost contribution agreement should be clear, not vague or open-ended. Therefore, it may be prudent for taxpayers to revisit their cost contribution agreements in light of this ruling.
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