What's New
News Flash

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CBDT circulars on application of profit split method and on identification of contract R&D service provider with insignificant risk

The Transfer Pricing ("TP") methodology for research and development ("R&D") services has been under the scanner of the Indian Revenue off late, with the Indian Revenue often trying to disregard a "contract R&D service provider" structure, with a cost plus model; and substituting the same with profit split method ("PSM"). This approach by the Indian Revenue had been on the ground that the Indian R&D centre had been developing the intangibles through the R&D functions virtually on its own; and thus should be entitled to the entrepreneurial related returns related to the intangibles (say patents).

In view of this increasing dispute and litigation with TP matters surrounding the characterization and remuneration model of the contract R&D service providers, the Rangachary Committee ("Committee") was *interalia* mandated by the Central Board of Direct Taxes ("CBDT") to introduce guidelines for the Indian Revenue and taxpayers.

The CBDT has now come out with two circulars – (i) on identification of contract R&D service provider with insignificant risk and (ii) on application of profit split method, based on the recommendation of the Committee. CBDT is of the view that these circulars will help in providing certainty and guidance to the taxpayers on issues relating to transfer pricing of development centre.

Following are the key aspects emanating from the above circulars:

Circular No 3/ 2013 - Conditions relevant to identify development centres engaged in contract R&D services with insignificant risk

This circular clarifies that a development centre in India may be treated as a contract R&D service provider with insignificant risk if the following conditions are cumulatively complied with:

	Foreign principal	**Indian development center ("IDC")**
Economically significant functions	✓	IDC is largely involved in economically insignificant functions
Funds/capital and other economically significant assets	✓	IDC does not use any other economically significant assets including intangibles

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Capability to control or supervise R&D function through its strategic decisions to perform core functions as well as monitor activities	✓	IDC works under direct supervision of foreign principal
Assumption of Risks	✓	IDC does not assume or has no economically significant realised risks
Ownership right (legal or economic) on outcome of research	✓	IDC has no ownership right on outcome of research which shall also be evident from conduct of the parties

The CBDT has emphasised on "substance" at the level of the foreign principal, as a pre-condition for the Indian R&D centre being accorded a "contract R&D service provider" status, which again, is fair and as per the guidelines of the OECD. The CBDT has mentioned that if the principal is located in a tax haven, the general presumption would be that it might not have necessary substance; however the CBDT had hastened to add that the said presumption would be rebuttable by the taxpayer through adducing necessary evidence around substance at the level of the principal.

Circular No 2/ 2013 on application of PSM

The CBDT has provided that since there is no correlation between cost incurred on R&D activities and return on an intangible developed through R&D activities, the use of transfer pricing methods [like Transactional Net Margin Method ("TNMM")] that seek to estimate the value of intangible based on cost of intangible development (R&D cost) plus a return, is generally discouraged.

Accordingly, the CBDT has reiterated the factors provided in Rule 10C (2) of the Income Tax Rules, 1962, that should be taken into account while selecting the most appropriate method. The CBDT has provided that in case PSM is otherwise applicable with respect to a transaction involving development of intangibles, then the Transfer Pricing Officer ("TPO") should not merely discard the same on the ground of non-availability of information/ data, since such information/ data should otherwise be available with taxpayers. Further, if the TPO were to finally discard PSM, then he should record reasons for doing so before considering TNMM or Comparable Uncontrolled Price ("CUP") method.

The CBDT then suggests that if the TPO does not apply PSM, presumably in a case where the situation otherwise demanded the adoption thereof, then the TPO might apply TNMM or CUP method with appropriate upward adjustments taking into account transfer of intangibles without additional remuneration, location savings and location specific advantages.

PwC Observations:

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, the Indian Revenue should not seek to apply PSM in all cases. This puts additional onus on the taxpayers to have robust documentation in place to establish the functional profile of the India R&D centre to demonstrate that it is low risk service provider bearing insignificant risks.

OECD, in its discussion draft on Chapter VI, relating to intangibles, had laid down some guidelines on R&D services, where the emphasis was clearly around establishing substance in the principal company, for the "contract R&D structure", with a cost plus model, being accepted by the Revenue. Accordingly, a proper functional, asset and risk ("FAR") analysis would be of paramount importance. It is extremely critical to determine the substantive FAR profiles of both the taxpayer and the foreign principal and the India development centre to characterise them properly, select the most appropriate method and decide the appropriate remuneration model.

It would also be of importance to consider the comments of the Indian Revenue to the UN's draft

Practical Manual on TP for Developing Countries in respect of allocation of risks. The Indian administration is of the view that risk is not an independent element, but is similar in nature to functions and assets. Further, the allocation of risk depends upon the ability of parties to the transaction to exercise control over risk.

The India chapter specifically takes an example of contract research & development (R&D) activities undertaken by Indian related parties of multi-national enterprises, and the Indian administration objects to these entities being risk free entities, entitled to (low) cost plus remuneration. The Indian administration challenges the ability of the foreign associated enterprises to exercise control remotely. The Indian administration contends that the Indian related parties undertake the core R&D activities and also take strategic operational decisions, and thus control substantial part of the risks. The Indian administration hence believes, that in such cases, allocation of routine cost plus return to the Indian related parties will not be arm's length.

It is difficult to fathom such a general comment being made in respect of inter alia R&D structures across-the-board. An evaluation of such structures would have to be case specific and would need to be undertaken independently based on a review of the significant people functions and conduct of the parties in each case.

Allocation of risk depends upon who exercises control over risk – eventually this will impact allocation of returns as well – on this point, the views of the UN and the OECD are in line with each other. The answer to the question as to who exercises control is based on a factual analysis. If the Indian taxpayer has to win an argument on facts, then, needless to say, the facts must be entirely substantiated and documented. Accordingly, it is of paramount importance that a proper FAR analysis is carried out by the taxpayer to determine which entity bears the significant risks (in line with guidance provided in Circular No. 3/ 2013 above). This shall also enable the taxpayer to determine the most appropriate method (i.e. PSM or TNMM / CUP) (in line with guidance provided in Circular No. 2/ 2013 above).

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