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News Alert
1 July 2013

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CBDT issues revised guidance on contract R&D centres

Background

Almost three months ago, pursuant to the recommendations of the Rangachary Committee[1], the Central Board of Direct Taxes (CBDT) had issued two circulars: (i) Circular 3[2] on identification of contract R&D service provider with insignificant risk and (ii) Circular 2[3] on application of profit split method (PSM). The stated purpose of the circulars was to provide additional guidance to the first level assessing officers, so that there is certainty and uniformity in assessments of development centres that are engaged in providing contract R&D services. This initiative was intended to design a fair tax system in line with international best practices so as to promote India as an investment destination.

However, instead, it turned out that the circulars generated more controversy and confusion than providing clarity.

As regards Circular 3, in particular, the terms 'economically significant' and 'economically insignificant' left the industry perplexed as to what exactly these meant. Moreover, 'cumulative' compliance with the various conditions listed in Circular 3 was considered to be rather stringent, and was thus another cause for concern. Also, the condition of foreign principal being located in a 'widely perceived low or no tax jurisdiction' was quite ambiguous. These concerns over Circular 3 have been acknowledged by the CBDT in a press release[4] issued on June 29, 2013.

[1] Appointed to review 'Taxation of Development Centres and the IT sector'.
[2] Circular 3/ 2013 (dated March 26, 2013)
[3] Circular 2/ 2013 (dated March 26, 2013)

[4] http://pib.nic.in/newsite/mbErel.aspx?relid=96897

Based on representations received from the industry on the two circulars, the CBDT has now issued Circular 5[5] which withdraws Circular 2, and has amended Circular 3 and reissued it as Circular 6[6]. Quite evidently, representations from the industry have been seriously considered and alterations have been made so as to provide the clarity that was lacking.

Circular 5 notifies withdrawal of Circular 2

From a reading of the press release issued on June 29, 2013 together with Circular 5, it is apparent that the Circular 2 has been withdrawn primarily for the reason that it gave the impression that there was a hierarchy amongst the methods listed in section 92C of the Income-tax Act, 1961 (the Act) and that PSM was the preferred method in cases involving unique intangibles or multiple interrelated international transactions. Further, it was considered that provisions of the Act and the Income-tax Rules, 1962 (the Rules) were itself quite comprehensive and clear and provided sufficient guidance on selection of most appropriate method (MAM).

Circular 3 amended and reissued as Circular 6

Circular 6 recognises that R&D centres set up by foreign companies can be classified into three broad categories based on their functions, assets and risks (FAR) as follows:

1. Centres which are **entrepreneurial** in nature;

2. Centres which are based on **cost-sharing** arrangements; and

3. Centres which undertake **contract** research and development.

As per the Circular, in the first case, the development centre performs significantly important functions and assumes substantial risks. In the third case, the FAR are minimal, while the second case falls between the first and third cases.

The above distinction made based on FAR, is more real and practical.

[5] Circular 5/ 2013 (dated June 29, 2013)
[6] Circular 6/ 2013 (dated June 29, 2013)

Having made this distinction, the CBDT proceeds to provide guidelines for identifying Indian Development centres (IDC) which fall in the third category, i.e., contract R&D centres with insignificant risks. In this regard:

- The usage of the term 'guidelines' in Circular 6 as against 'conditions' in Circular 3, is worth noting, and implies that Circular 6 is meant to provide guidance rather than provide a mandate.

- This is supported by the fact that Circular 6 does not require all guidelines to be 'cumulatively' satisfied, as was required by Circular 3.

- Moreover, Circular 6 requires the first level assessing officers to 'have regard to' the guidelines and to take a decision based on totality of facts and circumstances of the case.

Clearly, the approach being propagated by CBDT is more rational and less stringent, with an emphasis on the overall conduct and substance of the parties and the arrangement.

In-principle, the guidelines in Circular 6 are not substantially different from the conditions in Circular 3. However, modifications have been made in order to simplify and provide greater clarity. A comparative analysis of the conditions / guidelines in Circular 6 vis-à-vis Circular 3 is provided below (the changes made in the circulars have been italicised for ease of reference):

Circular 3 Conditions	Circular 6 Guidelines	Remarks
Economically significant functions to be performed by Foreign Principal (FP). *Economically insignificant functions to be*	Economically significant functions performed by FP (through its employees or through its AEs) *would include critical functions such as conceptualisation and design of the product and providing strategic direction and framework.*	Greater clarity provided on what is meant by 'economically significant functions'. Further, in order to simplify, the reference to '*economically insignificant functions*' in the context of IDC has been removed, and

Circular 3 Conditions	Circular 6 Guidelines	Remarks
performed by IDC.	IDC to perform *work assigned to it by FP.*	the amended circular 6 simply states that *IDC will perform work assigned to it by the FP.*
FP to provide funds/capital and other economically significant assets including intangibles. *IDC does not use any other economically significant assets including intangibles.*	FP or its AEs to provide Funds/capital and other economically significant assets including intangibles. *Foreign Principal (or its AE) also provides remuneration to IDC.*	In a contract R&D centre, as against an entrepreneurial set-up or a cost sharing arrangement, it would be the FP who would remunerate the IDC. This is possibly the reason why in Circular 6 "*Foreign Principal (or its AE) also provides remuneration to IDC"* has been added.
FP not only has the capability to control or supervise, but actually controls or supervises R&D through its strategic decisions to perform core functions as well as monitor activities on regular basis. IDC works under direct supervision of foreign principal.		No significant change
FP assumes and controls risks. IDC does not assume/ has no economically significant realised risks.		No significant change

Circular 3 Conditions	Circular 6 Guidelines	Remarks
If FP is located in a widely perceived low or no tax jurisdiction, it will be presumed that it is not controlling the risk. However, IDC may rebut this to the satisfaction of revenue authorities.	If FP is located in a widely perceived low or no tax jurisdiction, it will be presumed that it is not controlling the risk. However, IDC may rebut this to the satisfaction of revenue authorities. *Low tax jurisdiction to mean any country or territory notified under section 94A of the Act or any other country or territory notified for the purpose of Chapter X of the Act.*	Greater clarity provided on the meaning of the term 'low or no tax jurisdiction'.
Ownership right (legal or economic) on outcome of research vest with the FP and not with the IDC.		No significant change
In respect of all the above, emphasis is on conduct and not merely on the terms of contract.		No significant change
Circular 3 was silent on selection of MAM.	Section 92C of the Act; Rules 10A to 10C of the Rules; and above guidelines set out in Circular 6 to be borne in mind while selecting MAM.	In addition to the Act and the Rules, guidance in Circular 6 would also now need to be considered while selecting the MAM for R&D centres.

Alignment with international best practices

The CBDT has clearly attempted to align with international best practices. In the old Circular 3 as well as in the new Circular 6, the emphasis on substance, and conduct over contract, is in line with international guidance provided by the OECD and the United Nations (UN).

Further, for ascertaining whether or not the IDC is a contract R&D centre with insignificant risk, the CBDT has focussed on the FAR and related aspects of control, decision making, supervision, monitoring, capability, funds, etc. It is precisely these aspects which are also considered by the OECD and the UN when discussing contract R&D centres. The focus of the OECD and the UN in this regard is in fact more on who exercises control over risk, as compared to other factors. Therefore, by removing the condition of 'cumulative' compliance, the CBDT has in a way brought the guidance in Circular 6 closer to international guidance.

Overall a positive development

Overall, the withdrawal of Circular 2 and amendment of Circular 3 is a very welcome and proactive step taken by the CBDT. It is apparent from the above analysis that the changes made by the CBDT are meant to simplify, rationalise, enhance clarity and provide greater certainty.

In fact, since the guidance provided for contract R&D centres is based on fundamentals of transfer pricing, the same principles could even apply to other contract services entities of foreign companies, thereby clearing the air for many.

On a separate note, it is worth highlighting that, in the press release issued on June 29, 2013, the CBDT has stated that Safe Harbour Rules under section 92CB of the Act are under consideration and will be issued shortly, and this will bring further certainty in assessment of development centres that are engaged in providing contract R&D services.

From all the above steps taken by the CBDT, the intent of the Indian Government is evident, and the signal being sent out is obvious – India means business and is committed to attracting foreign investment.

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