India

Circulars on Transfer Pricing of Contract R&D Centres: The Road Ahead

With a view to establishing a degree of certainty and uniformity in the audits of development centres engaged in research and development activities, guidance has been provided to the tax authorities in the form of Circular 6. The authors discuss the contents of the new Circular, along with developments prior to its issuance and future prospects for taxpayers.

1. Introduction

Intangibles have always been a contentious issue for all transfer pricing regimes. In almost all jurisdictions, including the countries which have had a long history of implementation of transfer pricing regulations, developing a robust and consistent arm’s length structure for transactions pertaining to intangibles between associated enterprises has been fraught with dispute.

India has, in recent times, emerged as an important location for research and development (R&D) centres for multinational enterprises. These centres, which are normally subsidiaries of multinational enterprises, take advantage of the large pool of low-cost, high-skilled personnel. These centres function as in-house resource centres where all investments are done by the global affiliates. The work allocated to the Indian R&D centres varies according to the requirements of the global affiliates. The centres work as captive units for the group, whereby they provide contract R&D services to the group companies around the world. The services are spread across industries such as telecommunications, pharmaceuticals, automobiles and software.

On the other hand, India has also emerged as a hub of many Indian entrepreneurs establishing successful companies that undertake R&D work on an outsourcing model from independent customers around the world. Typically, these companies also have complex business models wherein they employ multiple personnel and offer a hybrid bouquet of services.

In such a landscape, there are multiple points of dispute that can arise between the Indian tax authorities and Indian taxpayers, namely the captive R&D centres. The first point begins with the determination of the level of functions and risks that are undertaken by the captive R&D centre. The Indian tax authorities have, in the past, split the requirements of the Indian R&D centre. In such cases, the Indian authorities have argued that application of the profit split method is more appropriate than expecting a routine cost-plus return.

In line with this particular viewpoint, chapter 10 of the UN Manual on Transfer Pricing also emphasizes substance over contractual relationship. It has been the contention of the Indian tax 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 subsidiary. Consequently, the ability of the parent company to control remotely 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 a substantial share of the risk and, thus, should be remunerated accordingly.

The second point of dispute, which is uniformly widespread, is the application of significantly higher mark-ups for such provision of services. Indeed, today a number of litigation cases are underway on matters such as the selection of comparables, markups and economic adjustments.

With a view to establishing a degree of certainty and uniformity in the audits of development centres engaged in R&D activities, guidance has been provided in the form of Circular 6.

This article considers the evolution of the Circular, international guidance and the road ahead following the issuance of this Circular.

2. Evolution of the Circular

In 2013, in an attempt to bring about greater clarity regarding taxation for the IT sector, the government of India constituted a committee, under the chairmanship of Mr N. Rangachary, that was given the mandate of addressing the approach to taxation of development centres. The overall goal was to have a fair tax system in line with best international practices, so as to promote India’s software industry and promote India as a destination for investment.

The journey to the current Circular can be illustrated as in Figure 1.

Based on the recommendations received from the Rangachary Committee, the Central Board of Direct Taxes (CBDT) issued two circulars on 26 March 2013 dealing...
with the development centres or contract R&D centres. These circulars specified the conditions to be met in order for a development centre to be deemed to engage in contract R&D services with insignificant risk, and provided guidance on applying the profit split method.

Approximately three months later, the CBDT – after considering representations on divergence of views between taxpayers and the tax authorities regarding the functional profile of development centres – rescinded the Circular pertaining to application of the profit split method. An amended Circular specifies conditions to be satisfied cumulatively by development centres engaged in contract R&D services in order to be identified as bearing insignificant risks.

### 3. Identification of Development Centres Bearing Insignificant Risk

The amended Circular indicates that based on the functional profile, the R&D centres set up in India by foreign companies can be classified into the following three categories:

- centres which are **entrepreneurial** in nature: they perform significantly important functions and assume substantial risks;
- centres which are based on **cost-sharing** arrangements: the functions, assets and risks assumed by these would fall between the entrepreneurial category and the contract R&D category; and
- centres which undertake **contract R&D**: the functions performed, assets used and risks borne are minimal.

The amended Circular states that the tax authorities will refer to the following guidelines and take a decision based on the totality of the facts and circumstances of the case when determining whether a development centre should be regarded as a contract R&D service provider bearing insignificant risk:

- most of the economically significant functions involved in the research or product development cycle are performed by the foreign principal, either through its own employees or through its associated enterprises, while the development centre carries out the work assigned to it by the foreign principal. Economically significant functions include critical functions such as conceptualization and design of the product and providing the strategic direction and framework;
- the foreign principal or its associated enterprise provides funds/capital and other economically significant assets (including intangibles) for the R&D. The foreign principal or its associated enterprise also provides remuneration to the development centre for the work carried out by the latter;
- the development centre works under the direct supervision of the foreign principal or its associated enterprise, which controls or supervises the R&D through its strategic decisions to perform core functions, and monitors activities on a regular basis;
- the development centre does not assume or has no economically significant realized risks. If the actual conduct of the development centre and the foreign principal are not in line with the contractual terms, those contractual terms will not be taken as the final determinant of actual activities;
- in the case of a foreign principal located in a **low- or no-tax jurisdiction**, it will be presumed that the foreign principal is not bearing the risk (unless proved to the contrary). A low-tax jurisdiction is any country or territory designated as such under section 94A of the Indian Income Tax Act (the ITA), or any other country or territory that is designated as such for the purpose of chapter X of the ITA; and
- the development centre has no ownership right (legal or economic) in the outcome of the research which vests with the foreign principal, and this is evident from the contract as well as from the conduct of the parties.

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1. Circular 05/2013 [F No 500/139/2012-FTD-I], dated 29-06-2013 (Withdrawal of Circulars No. 2 dated 26th March, 2013); Circular 06/2013 (amending Circular No.03/2013 dated 26th March 2013) – Circular on conditions relevant to identify development centres engaged in contract R&D services with insignificant risk.
Consider the comparison of Circular 6 with the earlier circular as in Table 1.

<table>
<thead>
<tr>
<th>Table 1: Comparison of Circular 6 with Circular 3</th>
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<tr>
<td>Economically significant activities</td>
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<td>Definition not provided</td>
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<td>Low-tax jurisdiction</td>
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<td>Terminology</td>
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<td>Basis of decision</td>
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<td>Other clauses</td>
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The current Circular is in line with the OECD discussion draft on Chapter VI – Intangibles. The guidelines in the Circular indicate that contracts could be the starting point of the analysis, although the conduct of the parties is the ultimate determinant when focusing on functions, risks and costs. The alignment of functional contributions and financial investment with legal rights is seen in the current Circular as well. The exercise of important functions by the foreign principal and control over service providers are factors that are in line with the OECD Guidelines.

4. The Way Forward

Whilst the CBDT has certainly taken positive steps to boost the confidence of taxpayers, one will have to wait to see how the tax authorities at the field level will interpret the new Circular and assess taxpayers undertaking contract R&D in India. The onus will be on taxpayers to maintain robust documentation to demonstrate the compliance with the guidelines set forth in Circular 6.

Taxpayers would be advised to proactively consider the impact of these circulars on their transfer pricing arrangements by mapping the functions and documentation with the guidelines provided in Circular 6. It is recommended that taxpayers undertake a detailed functional analysis of their international transactions and document the findings in support of their transfer prices, rather than rely on the contractual terms alone. With a view to achieving certainty, taxpayers would also be advised to consider seeking an advance pricing agreement where appropriate.