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CBDT Circulars: More ambiguity than clarity

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In continuation of the Budget 2013 speech made by the Finance Minister to provide certainty to the taxpayer and provide some comfort to the IT and ITES industry which has been facing significant tax pressures, the Central Board of Direct Taxes (CBDT) recently issued two circulars dealing with: (i) Circular 2/2013 on application of the profit split method¹ (“Circular 1”), and (ii) Circular 3/2013 on conditions relevant to identify development centres engaged in contract Research & Development (R&D) services with insignificant risks² (“Circular 2”). These circulars are based on the recommendations presented by the Rangachary Committee which was constituted by the Prime Minister to review the taxation of development centres and the IT sector because a number of IT and ITES companies have recently been facing litigation arising out of the tax holiday benefits that were granted to these companies.

I. Circular 1: Application of the Profile Split Method (PSM)

There has been no uniformity in application of the most appropriate method by the taxpayer and tax authorities, where the question revolved around taxing the R&D centres based in India. The CBDT *vide* Circular 1 tries to provide guidance for selection of the PSM as the most appropriate method for the purpose of calculating the arm's length price (ALP) in relation to an international transaction. This is further discussed below.

Selection of PSM over other methods: While selecting PSM as the most appropriate method for R&D activities, it must be kept in mind that the use of other transfer pricing methods such as the Transactional Net Margin Method (TNMM) are generally discouraged, as there is no correlation between costs and return on intangible developed.

Factors to be considered for application of PSM: The CBDT has reiterated the principles envisaged under Rule 10B (1)(d) and Rule 10C(2) of the Income Tax Rules 1962 (“Rules”) indicating that PSM may be applicable mainly in international transactions in-

volving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the ALP of any one transaction.

For the selection application of PSM as the most appropriate method, the following factors shall be taken into account:

- (a) The nature and class of the international transaction;
- (b) The class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;
- (c) The availability, coverage and reliability of data necessary for application of the method;
- (d) The extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
- (e) The nature, extent and reliability of assumptions required to be made in application of a method.

Recording the reason for non-availability of data: In a case where PSM cannot be applied to determine the ALP of international transactions involving intangibles due to non-availability of information and reliable data, the Transfer Pricing Officer (TPO) must record the reasons for non-applicability of PSM before considering TNMM or the Comparable Uncontrolled Price method (CUP) as the most appropriate method depending upon facts and circumstances of the case.

Onus on taxpayer: It provides that the onus of providing good and sufficient reason for non-availability of information on the taxpayer.

Power of TPO to make upward adjustments: Interestingly, Circular 1 clarifies that based upon the facts and circumstances of each case, the TPO has the power to make upward adjustments rejecting the PSM and to consider the selection of TNMM or CUP as the most appropriate method. While making upward adjustments, factors like transfer of intangibles without

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additional remuneration, locations savings and location specific advantages have to be considered.

II. Circular 2: Conditions relevant to identify development centres engaged in R&D services with insignificant risks

With regard to the ongoing tussle between the taxpayer and TPO on whether a Development Centre in India (IDC) can assume to be a risk-bearing entity or not, the CBDT has made an attempt to mitigate the same. Circular 2 provides that an IDC may be treated as a contract R&D service provider with insignificant risks if the following conditions are complied with cumulatively:

- (i) **Economically significant functions:** The foreign principal of IDC assumes economically significant functions involved in research and development of the product, whereas the IDC is involved only in economically insignificant functions;
- (ii) **Economically significant assets:** Funds, capital, and other significant assets including intangibles for research and product development would be provided by the foreign principal, whereas the IDC would not use any other economically significant assets including intangibles in research and development of the product;
- (iii) **Control and supervision:** The IDC only works under the foreign principal which has the capability to actually control and supervise the research and product development, perform core functions and monitor activities on a regular basis;
- (iv) **Conduct of parties' v. contractual agreement:** The IDC neither has nor assumes any economically significant realised risks. The CBDT has clarified that even if under the contractual terms, the foreign principal is controlling the R&D, but the conduct shows that the IDC is actually the one in control, the contractual terms shall not be the final detriment of the actual activities.
- (v) **Legal or economic ownership:** The IDC has no legal or economic ownership rights on outcome of the research. The outcome of the research should vest with the foreign principal and it shall be evident from the conduct of the parties.

The CBDT has gone one step further and stated that in case the foreign principal is located in a low/nil tax jurisdiction, it shall be presumed that the foreign principal is not controlling the risk. However, the IDC may refute this presumption to the satisfaction of the revenue authorities;

However, the CBDT has added a qualifying statement in the circular stating that the conditions to treat an IDC may be treated as a contract R&D service provided with insignificant risks, which shall be based on the conduct of the parties and not merely the contractual terms.

III. Analysis

Even though the CBDT has provided clarification regarding conditions that should be relevant to the entities engaged in R&D services, and will definitely have bearing on the future transfer pricing developments in India, the said Circulars bring no clarity nor address the transfer pricing controversies relating to

how the environment of tax certainty can be achieved. The outlined guidance is very much part of the existing transfer pricing regulations.

It is uncertain what the CBDT had in mind when issuing Circular 1. Despite the fact that it provides for the application of the PSM, it is essential to note that the CBDT has just reiterated the principles provided in the Rules and no new guidance has been provided. Without providing any reasonable basis, Circular 1 provides that the most appropriate method should be PSM instead of TNMM since there is no correlation between costs incurred on R&D activities and return on an intangible developed through such R&D activities. Thus, the circular adding to the ambiguity makes it even more difficult to decipher when PSM should apply. In this regard, it is essential to note that in the OECD Transfer Pricing Guidelines for Multinational and Enterprises and Tax Administrations Report on Intangibles ("OECD TP Guidelines"), various alternatives while selecting the most appropriate method in a matter involving the use or transfer of intangibles are provided. PSM may be used as the most appropriate method in cases such as: (i) where reliable uncontrolled transactions cannot be identified for sales of goods or services involving the use of intangibles; (ii) transfer of intangibles or rights to intangibles where it is not possible to identify reliable comparable uncontrolled transactions; (iii) where limited rights in intangibles are transferred in a licence or similar transaction, and reliable comparable uncontrolled transactions cannot be identified, the PSM can be utilised to evaluate the respective contributions of the parties to earning combined income; (iv) where there is the sale of full rights in intangibles; (v) where there is a transfer of partially developed intangibles. However, Circular 1 makes no reference to any of these cases while providing for the applicability of PSM.

Circular 2 elaborates on the FAR analysis in order to determine the test of risk bearing with the added emphasis on the importance to the conduct of the parties. However, these conditions are not conclusive and the foreign principal will not be considered as contracting the risk if the foreign principle is located in a jurisdiction perceived to be a low or no tax jurisdiction. Circular 2 does not list out what CBDT means by low or no tax jurisdiction and it will now be incumbent on the taxpayer to, together with, maintaining all the necessary documentation to prove that the location of the foreign principle is not in the low or tax jurisdiction. However, it seems that the CBDT has taken regard to the UN Practical Transfer Pricing Manual for Developing Countries ("Manual") which has provided a section for the emerging transfer pricing challenges in India with a special section for intangibles and R&D activities. The Manual provides that the R&D centres in India are considered high risk centres and hence considered by the TPO as the place which controls the risk and the development of intangibles. The Manual provides for various issues faced by R&D centers and their treatment by the TPO. However, the rules laid by CBDT in Circular 2 are very general and do not account for specific situations as has been mentioned in the Manual.

It is difficult to comment on these circulars due to the vagueness and subjectivity in the language provided therein. Every case would have to be dealt with

on a fact specific basis keeping these circulars in mind. These conditions remain open to broad interpretation which not only causes hardship to the taxpayers but also fails to provide any necessary guidance.

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NOTES

¹ Circular No.2/2013 on application of the profit split method, F No.500/139/2012 dated March 26, 2013.

² Circular No.3/2013 on development centers engaged in contract Research & Development services, F No.500/139/2012 dated March 26, 2013.