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India Favors Profit Split for Intangibles, Sets Conditions for Insignificant R&D Risk

NEW DELHI–India's Central Board of Direct Taxes March 26 issued a circular identifying the profit split method as the most appropriate for pricing related-party transactions involving intangibles and released a second circular laying out the requirements that must be satisfied in order for a research and development center to be classified as a contract R&D unit with ''insignificant risks.''

Circular No. 03/2013, ''The Conditions Relevant to Identify Development Centres Engaged in Contract R&D Services with Insignificant Risk,'' provides that in determining the risk levels assumed by the Indian development center, five cumulative conditions must be met in order to characterize the unit as an insignificant-risk-bearing entity.

Circular No. 02/2013, ''Application of Profit Split Method,'' mandates the use of the profit split method as the most appropriate method for related-party transactions involving R&D activities that lead to the creation of intangibles as well as for international transactions involving intangibles, including marketing intangibles.

The circulars appear in the Text section of this issue.

Ashutosh Mohan Rastogi of Amicus Advocates & Solicitors told BNA March 30 that the two circulars constitute the first set of promulgations by the Tax Department giving operational guidance for complex transfer pricing issues.

Rastogi said although arguably belated, the circulars are nevertheless a much needed response to long-standing demands for clarification on the government's position on R&D services.

Circular No. 3's five-pronged test for identifying contract R&D services is quite stringent, Rastogi said. ''Merely controlling the R&D activity is not enough, and the funding for R&D activity must also be provided by the foreign principal.''

Rastogi said Circular No. 2 is vague and provides no new guidance.

Indian R&D Centers. Circular No. 03/2013 deals with the determination of arm's-length pricing regarding R&D activities carried out by a back office unit in India.

The circular states that while some taxpayers have insisted that they are contract R&D service providers with insignificant risk, the transfer pricing officers have treated them as full, or significant-risk-bearing, entities.

The circular says that in future a development center in India may be treated as a contract R&D unit with insignificant risk if the following five conditions are complied with:

- the foreign principal performs most of the economically significant functions involved in the research or product development cycle;
- the foreign principal provides capital and other economically significant assets, including intangibles for research or product development;
- the foreign principal must actually directly supervise the R&D activity of the Indian development center, with the principal making strategic decisions regarding core functions, as well as monitoring the R&D activities;
- the Indian development center does not assume any economically significant risks; and
- the Indian development center has no legal or economic ownership right in the results of the research.

These five conditions, the circular adds, have to be satisfied, in substance, and not merely demonstrated through contractual arrangements.

In the case of the foreign principal being located in a jurisdiction widely perceived as a low-tax jurisdiction, the circular presumes that the foreign principal is not controlling the risk. However, the Indian development center may seek to rebut this presumption.

Economically Significant Risks. Rastogi said the Circular does not clarify the concept of ''economically significant functions.'' Perhaps guidance may be taken from OECD discussion draft on intangibles which refers to a similar concept of ''significant people functions,'' he said.

Regarding economically significant risks, Rastogi said the intercompany allocation of risks through related-party contracts is important but not conclusive.

Rastogi said contractually Indian development centers may have been shielded from various risks—for example the risk of failed research—through cost plus remuneration. However, if strategic decisions driving the research are taken by the Indian development center

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and not by the principal, the Indian center is controlling the risk as a practical matter.

Rajesh Gandhi of Deloitte Haskins & Sells in Mumbai agreed with Rastogi that Circular No. 3 has left a number of issues unresolved. To bring certainty, it would have been useful if the CBDT could have through examples illustrated what can be considered to be economically significant functions, assets and risks.''

Tax Havens. Sudhir Nayak of Sudit K. Parekh & Company, New Delhi said the most worrying aspect of the circular is the presumption that if the foreign principal is in a low-tax jurisdiction, it is not controlling the risk.

''The exercise of determination of significant risk should be decided primarily by the entity which bears the losses that may arise in case of a project failure, and not the level of taxability in the host country,'' he said.

Gaurav Shah of MZSK & Associates in Mumbai was also surprised at this aspect of the circular. ''Surprisingly, in cases where the principal is located in a perceived tax haven, it will be presumed that the principal is not controlling the risks.''

''While this is a rebuttable presumption, it appears to be uncalled for, since Indian regulations anyway empower the revenue authorities to conduct enquiries as they deem fit,'' he said.

An even more critical view was expressed by Ajit Tolani of Economic Laws Practice, Mumbai, who warned that the five cumulative conditions prescribed in Circular No. 3 would, far from bringing greater clarity as intended, only create more confusion.

''The tax authorities will try to poke holes in the functional, asset, and risk analysis to prove that some of the cumulative conditions were not satisfied and hence the Indian development center would be treated as risk bearing entity.

Profit Split Method. Turing to Circular No. 02/2013, Gandhi said the circular could have provided greater clarity if the circular had explained, through examples, the type of transactions that may be considered to involve intangibles.

''This circular has made PSM the default method for transactions involving intangibles in so far as the transfer pricing officer is required to record his reasons for not adopting PSM,'' he said.

In cases involving the transfer of unique intangibles, or multiple interrelated international transactions, generally the transactional net margin method or comparable uncontrolled price method was used as the most appropriate method, pointed out Nayak.

Nayak said the new circular directs the transfer pricing officer to record the reasons for not selecting the profit split method. ''This means that the CBDT implicitly admits the application of PSM as the most appropriate method for entities engaged in R&D activities.''

Challenges. Shah said taxpayers could be faced with several challenges.

First is the element of subjectivity, Shah said. ''Unlike CUP or TNMM, since PSM evaluates the relative contribution of both or all associated enterprises to the overall profit generated in an economic activity, it is inherently more subjective in nature as compared to the other methods and there is very little practical guidance available regarding the use of PSM.''

Second is the availability of relevant information. ''In my experience, the overseas counterparts of Indian entities are generally very reluctant to share confidential information. Incomplete information can throw up radically skewed results under PSM,'' said Shah.

Third, is loss sharing. ''Tax officers have to record their reasons for deviating from PSM, but considering their tendency to expect significant profits in India, it remains to be seen how they will approach PSM in cases involving losses, say, on account of failed R&D initiatives,'' said Shah.

Selection Criteria. Circular No. 02/2013 states: ''Since there is no correlation between the cost incurred on R&D activities and the return on an intangible developed through R&D activities, the use of transfer pricing methods such as the TNMM that seek to estimate the value of an intangible based on the cost of intangible development (R&D cost) plus a return, is generally discouraged.''

Regarding international transactions, the circular says that the tax rules provide for the profit split method to be applied mainly in international transactions involving the 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 arm's length price of any one transaction.

The circular says the selection and application of the profit split method will depend upon the:

- nature and class of the international transaction;
- classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed and risks assumed;
- availability, coverage, and reliability of data necessary for application of the method;
- degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprise entering into such transactions;
- extent to which reliable adjustments can be made to account for differences between the international transaction and the comparable uncontrolled transaction; and
- nature, extent, and reliability of assumptions required to be made in application of the method.

The CBDT says that it is evident that the availability, coverage, and reliability of data necessary for the application of profit split method is one of the several factors in its selection as the most appropriate method.

Transfer Pricing Officers. The circular states that the transfer pricing officer must record the reasons for not using the profit split method to determine the arm's-length price of international transactions involving intangibles, including lack of reliable data, before considering TNMM or CUP as the most appropriate method depending on the case.

The circular goes on: ''The officer may consider TNMM or CUP as the best method by selecting comparables engaged in the development of intangibles in the same line of business and make upward adjustments, taking into account the transfer of intangibles without additional remuneration, location savings and location specific advantages.''

Greater Clarity? Gandhi said that a combined reading of the two circulars shows that the CBDT believes that if the R&D center is not assuming significant risks and fails to satisfy all conditions mentioned in Circular No. 3, then the TNMM or the CUP method may be applied for determining the arm's-length compensation for the Indian entity.

''Further, where any of the conditions in Circular No. 3 is not satisfied, it appears that it would be presumed that the intangibles are developed by the Indian R&D center and circular No. 2 would apply,'' he said.

By Amrit Dhillon and Kevin A. Bell