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## Contents

**Article**
Transfer pricing and contract research centres in India ........ 2

**Circulars** ........ 4

**Ratio Decidendi** ........ 5

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## Article

# Transfer pricing and contract research centres in India

By **Sumeet Khurana**

Globalization coupled with high skill at low cost feature of India has prompted many Multinational Enterprises ('MNEs') to outsource their business segments to India. With the passage of time, dimensions of outsourcing have extended to niche areas like Research and Development ('R&D') as well. MNEs in developed countries that are shifting their R&D functions to India, wholly or partially, need to be cautious about their taxation, especially Transfer Pricing (TP).

### *Conceptual background from a Permanent Establishment perspective*

The Indian Supreme Court in 1953[1] had held that a systematic and habitual activity having special skill and competency in executing the task assigned is sufficient to create a taxing nexus, referred to as 'business connection'. The term 'business connection', though much broader than the definition of a PE, falls on the same concept of a nexus between the business of the foreign enterprise and activities carried out within a taxing jurisdiction.

OECD commentary on Model Tax Convention has maintained a position, since 1963, that research activities are preliminary and auxiliary to the actual realisation of profits by an enterprise and that no profit can be attributed to such research activity. Similar is the position of maintaining a place for mere purchase function.

Skaar[2] also supports OECD view *de lege lata* however comments that the same is not persuasive *de lege ferenda.* It appears that in harmony with the view of Supreme Court, Indian tax administration has given its observations on OECD commentary that it does not agree with the interpretation given [regarding research activities] and it would not include scientific research in the list of examples of activities indicative of preparatory or auxiliary nature.

### *Transfusion of the concept into Transfer Pricing (TP) regulations*

In the Practical Manual on TP for developing countries released by United Nations, a separate chapter is devoted to country specific practices. Indian tax administration expressed therein that R&D efforts in India require a proper compensation, which could be by way of imputing royalties for use of know-how developed in India. The practice of MNEs providing a low cost plus mark up on the ground that they control all the risk and their Associate Enterprise (AE) operating in India are risk free or limited risk bearing entities was also condemned in that chapter.

On similar lines Bangalore Bench of the Income-tax Appellate Tribunal ('ITAT'), in the case of GE India Technology Centre[3] held that the ability of the foreign AE to exercise control over risks remotely from the place where the core

1 Anglo French Textile Co. Ltd. V. CIT 23 ITR 101 (SC) (4 Judge Bench)

2 Arvid Skaar, *Permanent Establishment, Erosion of Tax Treaty Principle*

3 GE India Technology Centre (P.) Ltd. v. DDIT [2013] 141 ITD 245 (Bangalore)

R&D functions (carried on by Indian taxpayer) are not located is very limited.

The Central Board of Direct Taxes[4] (CBDT) issued two circulars in the year 2013 viz. Circular 2/2013 and Circular 3/2013. Circular 3/2013 laid down five conditions to be cumulatively satisfied so as to demonstrate that the Indian entity providing R&D services is a risks mitigated entity. Circular 2/2013 stated that Profit Split Method would be the best method for determining Arm's Length Price (ALP) of remuneration of the Indian entity engaged in R&D activities, in case any of the condition mentioned in Circular 3/2013 is not satisfied.

## *Current scheme of TP regulations for R&D centres*

The above circulars were later withdrawn and replaced by Circular 6 of 2013. The latest circular states that R&D centres in India can be classified into (a) entrepreneurial in nature, (b) cost-sharing arrangements; and (c) contract R&D. The new circular lays down following guidelines for determining whether the Indian entity is engaged in contract R&D activities and assumes insignificant risks.

a) Foreign AE performs most of the economically significant functions like conceptualization, design, providing strategic direction and framework, involved in research while the Indian R&D Centre carries out the work assigned to it;

b) Foreign AE provide funds and significant assets required for the research;

c) The R&D Centre works under the direct supervision of the foreign AE;

d) The R&D Centre does not assume or has no economically significant realized risks, both in substance and in form;

e) An AE located in low or no tax jurisdiction will be presumed to be bearing no risks. The presumption can however be rebutted with evidence.

f) The R&D Centre has no ownership right (legal or economic) on the outcome of the research, both in substance and in form.

These guidelines are largely in line with the OECD recommendations as they flow from revised discussion draft on Transfer Pricing Aspects of Intangibles dated July 30, 2013. Experience of Indian administration has been that even those entities who claim to have met these conditions fail to corroborate their claims with sufficient documentary evidence. Maintaining a robust documentation is therefore crucial for sustainability of the position adopted.

## *Managing the risk*

The change in the approach of tax administration is definitely welcome. Further, the tax policy framework offers options like (a) safe harbour rules and (b) advance pricing agreements that can be used to reduce the risk of any divergent view being taken by tax officers leading to unwanted litigation.

### *a. Safe harbour*

CBDT in September, 2013 announced the Safe Harbour Rules providing that the transfer price declared by the taxpayer engaged in rendering contract R&D services in the light of circular 6 above would be accepted if its

[4] Apex authority for Indian direct tax administration

operating profit / operating expenses is not less than 29%[5] / 30%[6].

*b. Advance Pricing Agreement (APA)*

The Indian APA scheme was introduced by the Finance Act 2012, with effect from July 1, 2012. Corresponding rules for effective implementation were announced on August 30, 2013. The scheme has been quite popular amongst the taxpayers.

The scheme provides for pre-filing consultation, a preliminary processing of the application, across the table discussions, site visits by tax officers, post APA compliance and reduced scope of audit by tax officers. The regime envisages unilateral, bilateral as well as multilateral APAs. Recently in Fiscal Budget 2014 the scheme has been further expanded to cover roll back upto four past years in addition to five subsequent years.

### *Concluding remarks*

Keeping pace with industrial development and business dynamics, the role of R&D in profit generating process has been realised to be significant enough to warrant profit attribution and deserving ALP consideration in PE and subsidiary scenarios respectively. Considering the fact that determining the nature of R&D activities is a fact based exercise and there can be subjectivity in evaluating the functional profile of a captive R&D centre, proper documentation should be maintained to demonstrate compliance with conditions mentioned in Circular 6/2013. Taxpayers should also consider opting for an APA which, with roll back provisions can provide certainty for good nine years.

**[The author is Director, Direct Tax Practice, Lakshmikumaran & Sridharan, Chandigarh]**

## Circulars

### Tax-payer friendly regime – CBDT instructions

The CBDT has advised its officers to adopt a tax-payer friendly regime both in letter and spirit. To achieve this objective of creating a tax-payer friendly regime, CBDT has identified a slew of measures as communicated by O.M. D.No.279/ Misc./52/2014-(ITJ) dated 7-11-2014. These include strict adherence to the appointment time given to the tax payers, avoiding frivolous additions or high-pitched assessments without proper basis, improving quality of assessments, limiting the scrutiny to only that information contained in the AIR/CIB/26AS wherever the scrutiny is based on those documents and granting credit to the assessee on the basis of evidence of TDS. It directs the Commissioners (Appeal) to specify the particular point on which the matter is being remanded, the Assessing Officer to submit remand report only to the specific point and also, asks the department not to file appeals which lack merit and not to file appeals before the Supreme Court in case where no substantial questions of law is required to be decided. The Board has also advised that summons should be issued only

[5] For contract R&D services (wholly or partly) relating to generic pharmaceutical drugs

[6] For contract R&D services (wholly or partly) relating to software development

in deserving cases duly informing the person summoned for which specific purpose he has been summoned.

### Threshold for approaching settlement commission

Section 245A(b) of the Income-tax Act permits an assessee to approach the Settlement Commission, in respect of any assessment year where the assessment is pending. In pursuance of the above provision, CBDT had clarified vide Circular 3/2008 stating that assessment shall be deemed to be completed on the date of service of assessment order to the applicant. Taking advantage of such a clarification contained in the circular, taxpayers used to file application before the Settlement Commission, so long as the assessment order had not been received by them. By Circular No.16/2014 dated 17-11-2014 stating that its earlier clarification to be inadvertently erroneous, the Board has clarified that "the assessment shall be deemed to have been completed on the date on which the assessment order is passed".

While the earlier clarification that '*service* of assessment order on the order' is a pointer for completion of the assessment was at one extreme, the current clarification that the date on which the Assessing Officer passes the assessment order will be reckoned for the purposes of the completion of the assessment appears to be another extreme. Judicial precedents support a view that the date of putting the assessment order in the course of transmission should be reckoned as the date for the purposes of completion of assessment.

## Ratio decidendi

### *Cross-border transactions*

### Disallowance for failure to deduct TDS on non-resident payments should not apply if recipient has offered its income for tax

The taxpayer, a subsidiary of a Japanese parent company, made certain payments to its parent company, but failed to deduct tax at source. Revenue authorities disallowed the payment by invoking Section 40(a)(i). The taxpayer contended that no disallowance is called for when similar payments are made to residents if the recipient includes such income in its return. Thus the non-resident is discriminated as similar exception is not carved out in Section 40(a)(i). It was held by the ITAT that such exception must also be read into Section 40(a)(i) to remove the alleged discrimination since parent company had included the sum received in its return. [*Mitsubishi Corporation India Pvt. Ltd.* v. *DCIT*, ITA No. 5042/Del/11, ITAT Delhi, Order dated 21-10-2014]

### UK LLP qualifies as 'person' under India-UK treaty

The taxpayer, an LLP in UK engaged in the business of shipping in international waters claimed the benefit of Article 9 of India -UK treaty by virtue of which the profits were to be taxable only in UK. Revenue authorities contended that the taxpayer cannot be considered as resident of UK as it was not a person liable to tax in UK. Calcutta High Court has held that LLP is treated as 'person' under Indian Income Tax Act and thus, by virtue of Article 3 (2) of India-UK treaty the UK LLP qualifies to a person under the treaty and is resident of UK . Accordingly, it was held that the taxpayer is entitled to avail treaty benefit with respect to shipping income. [*P&O Nedlloyd Ltd.* v. *ADIT*, W.P Nos. 457 and 458 of 2005, Calcutta High Court, Judgment dated 7-11-2014]

### Payment towards installation charges of equipment not taxable as fees for technical services

The taxpayer, a newspaper publisher entered into distinct contracts with a Swiss entity for supply and installation of mailroom equipment. Revenue authorities disallowed the payment towards installation charges for non-deduction of tax at source. The ITAT observed that the mailroom equipment comprised of various components and hence was complex equipment; that the installation services involved brining and positioning various components and properly aligning them while connecting individual units and qualified to be an 'assembly' which is excluded from the definition of fees for technical services. Accordingly, tax is not required to be deducted on payment made towards installation and commissioning of mailroom equipment. [*ITO* v. *Bennet Coleman & Co. Ltd*, ITA No. 57 of 2009, ITAT Mumbai, Order dated 12-11-2014]

### Rule 10BA on 'other methods' will have retrospective applicability

Rule 10BA of the Income Tax Rules introduced a residuary method for arriving at ALP with effect from 01-04-2012 while taxpayer sought to apply this method for a period prior to 2012. The ITAT observed that a legislation that confers a benefit without inflicting a corresponding detriment and where to confer such benefit appears to have been the legislators object, then the presumption would be that such a legislation would warrant it to be given a retrospective effect. The Tribunal thus held Rule 10BA to have retrospective applicability. [*Toll Global Forwarding India Pvt Ltd* v. *DCIT*, ITA No. 5025/Del/10, ITAT Delhi, Order dated 19-11-2014]

## *Domestic transactions*

### Payment for transmission charges does not attract Section 194I

The taxpayer, engaged in business of distributing and transmitting power, was availing transmission services however did not deduct TDS on transmission charges. The Tribunal held that section 194I is not attracted where the control and possession of the asset in legal sense is with the recipient of income. On facts it found that the payment was made only for the purpose of specific act, i.e. transmission of power, and even if an asset is used in the said process the payment cannot be said to be for the use of an asset by the payer. [*Maharashtra State Electricity distribution Company Ltd.* v. *ACIT,* ITA No. 6212 of 2012, ITAT Mumbai, Order dated 29-10-2014]

### Toll road is not a plant for the purpose of depreciation

The taxpayer, a subsidiary of NHAI, formed for constructing the highway on Build, Operate and Transfer (BOT) basis, constructed the toll road and treating it as a 'Plant' claimed depreciation @ 25%. Revenue authorities treated it as 'building' and allowed depreciation @ 10%. The High Court held that 'plant' means tool or equipment used for the purposes of business or profession per contra toll road is a capital asset which is the very business of taxpayer and not a 'tool' used for business. [*Moradabad Toll Road Co. Ltd. v. ACIT*, ITA No. 51 of 2013, Delhi High Court, Judgment dated 5-11-2014]

### No depreciation can be claimed on toll roads built by the taxpayer on Build Operate Transfer ('BOT') basis

The taxpayer, an infrastructure developer entered into a concession agreement with NHAI to construct toll roads under BOT arrangement and claimed depreciation on the roads so built. The High Court held that government is the owner of the toll road built and taxpayer gets only a limited right under the NHAI Act. Accordingly, depreciation on toll road was denied as the taxpayer was not the owner of the toll roads. [*North Karnataka Expressway Ltd* v. *CIT*, ITA No. 499 of 2012, Bombay High Court, Judgment dated 14-10-2014)

### Interest from funds parked under business compulsion is 'business income' for claiming deduction under Section 80I

The taxpayer, made fixed deposits on the insistence of the financial institutions and received interest income whereon it claimed deduction under Section 80I. Tax authorities denied the 80I claim on interest income. It was held by the High Court held that interest from the fixed deposit placed out of business compulsion cannot be treated as 'income from other sources' and must be seen as part of the taxpayer's 'business income' and thus 80I deduction on the same shall be allowed. [*Empire Pumps Pvt. Ltd.* v. *ACIT*, ITA No. 186 of 2013, Gujarat High Court, Judgment dated 14-11-2014]

### No disallowance under Rule 8D(ii) where interest expense attributable to business assessable to tax

The taxpayer, primarily engaged in the business of manufacture and sale of sugar, had invested certain sum in shares and earned dividend. The shares were found to have been purchased out of own funds year in 1993. The term loans on which interest was paid during the year under consideration were received for specific purposes and the cash credit account was used for the working capital of the business. The department disallowed interest expense on borrowed funds under Section 14A. The High Court held that no disallowance can be made under Rule 8D(ii) once it is established as a fact, that interest bearing borrowed funds were used for business which is assessable to tax. [*Dharampur Sugar Mill Ltd.* v. *ACIT*, ITA No. 220 of 2014, Allahabad High Court, Judgment dated 5-11-2014]