Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes
(Foreign Tax and Tax Research-I Division)

PRESS RELEASE

Chapter X of the Income-tax Act, 1961 contains special provisions relating to avoidance of tax. Terms such as 'associated enterprise', 'international transaction', 'intangible property', and 'specified domestic transaction' are defined in different sections of the Chapter.

Section 92C provides that the arm's length price in relation to an international transaction or specified domestic transaction shall be determined by any of the methods listed thereunder, being the most appropriate method, having regard to the nature of transaction or class of transactions or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe. The methods listed are:

(a) comparable uncontrolled price method;

(b) resale price method;

(c) cost plus method;

(d) profit split method;

(e) transactional net margin method;

(f) such other method as may be prescribed by the Board.

Sub-section (2) of section 92C provides that 'the **most appropriate method**' referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed (*emphasis supplied*).

Section 92CA enables the Assessing Officer, if he considers it necessary or expedient to do so, with the previous approval of the Commissioner, to refer the computation of the arm's length price in relation to an international transaction

or specified domestic transaction under section 92C to the Transfer Pricing Officer.

Section 92CB provides that the determination of arm's length price under section 92C or section 92CA shall be subject to safe harbour rules. 'Safe harbour' has been defined as circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee.

Rules have been made to carry out the mandate of the above sections. These are contained in Rules 10A, 10AB, 10B and 10C. Attention is drawn to Rule 10B which provides that the arm's length price shall be determined by any of the methods listed thereunder, **being the most appropriate method**, in the manner provided thereunder. The rule further provides how each of the methods will be identified and applied. In so far as it concerns 'profit split method' the rule provides that the said method *'may be applicable mainly in international transactions involving 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.'*

Rule 10C is extracted fully hereunder:

(1) For the purposes of sub-section (1) of section 92C, the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length price in relation to the international transaction.

(2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account, namely:-

(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 degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;

(e) 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;

(f) the nature, extent and reliability of assumptions required to be made in application of a method.

The crux of Rule 10C is that the Assessing Officer or the Transfer Pricing Officer, as the case may be, shall take into account the factors enumerated thereunder and choose the most appropriate method "which is best suited to the facts and circumstances of each particular international transaction" and which provides "the most reliable measure of an arm's length price" in relation to that transaction.

The provisions of the Act and the Rules made thereunder were quite comprehensive and clear and provided sufficient guidance to the Assessing Officer as well as to the Transfer Pricing Officer. Nevertheless, it was felt that it may be desirable to appoint a Committee to review 'Taxation of Development Centres and the IT sector'. The stated goal was to have a fair tax system in line with best international practice which will promote India's software industry and promote India as a destination for investment and for establishment of Development Centres.

The Committee under the Chairmanship of Shri N Rangachary, former Chairman, CBDT, submitted its First Report on Taxation of Development Centres and IT Sector in September, 2012. Based on the Committee's report and after carefully considering the matter, the CBDT issued circular No.2/2013 and circular

No.3/2013 on 26th March, 2013. Circular No.2 was titled "Circular on application of profit split method" and Circular No.3 was titled "Circular on conditions relevant to identify Development Centres engaged in contract R&D services with insignificant risk".

The purpose of the circulars was to provide additional guidance to the Assessing Officer or the Transfer Pricing Officer, as the case may be, so that there is a degree of certainty and uniformity in assessments of Development Centres that are engaged for providing contract R&D services.

Representations have been received from the IT industry on the two circulars. It has been pointed out that the R&D Centres set up by foreign companies can be classified into three broad categories based on functions, assets and risk assumed by the centre established in India and these are:

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.

It has been represented that there is a need for providing maximum clarity on the principles for distinguishing each of the three categories and identifying the most appropriate method for determining the arm's length price/transfer pricing.

The matter has been reviewed in the light of the representations received. The content and the language of the circular No.2 and circular No.3 have also been reviewed. In the light of the review, the CBDT has decided to:

(1) Rescind circular No.2/2013 dated 26th March, 2013.

(The circular appeared to give the impression that there was a hierarchy among the six methods listed in section 92C and that Profit Split Method (PSM) was the preferred method in the case involving unique intangibles or in multiple interrelated international transactions.)

(2) Amend and reissue circular No.3 dated 26th March, 2013

(While the circular listed the conditions that would be relevant to decide whether a Development Centre is a contract R&D service provider with insignificant risk, the use of the phrase 'cumulatively complied with' was perhaps too restrictive. It is also felt that

phrases such as 'economically significant functions' and 'low or no tax jurisdiction' need to be defined or elaborated. Hence the need to amend and reissue the circular.)

CBDT believes that the rescission of circular No.2 and amendment and reissue of circular No.3 will clear all ambiguities in the matter. Safe Harbour Rules under section 92CB of the Act are under consideration and will be issued shortly by the CBDT and the Safe Harbour Rules will bring further certainty in assessment of Development Centres that are engaged in providing contract R&D services.