Advance Pricing Agreements: The Journey Thus Far

The authors review the Indian advance pricing agreement programme and experiences to date.

1. Backdrop

The taxation tug-of-war between multinational companies (multinationals) and the Indian tax authorities has been a never-ending story. The transfer pricing regulations, which have been a long-drawn contentious issue between the tax authorities and multinationals, recently came into the limelight after certain multinationals were slapped with hefty tax demands for allegedly entering into international transactions with their associated enterprises at non-arm’s length prices.

In each round of audit, the Indian tax authorities have ventured into new controversies in areas such as marketintangibles, share valuation, corporate guarantees, business restructuring and location savings, in addition to attributing high markups for routine activities. With close to USD 10 billion of adjustments being made in the eighth round of transfer pricing audits, transfer pricing has gained paramount importance for both taxpayers and the tax authorities. With such huge adjustments, the Indian tax authorities are reckoned as tough in transfer pricing matters, with India accounting for approximately 70% of all global transfer pricing disputes by volume.

With significant uncertainties existing in the approach of the Indian tax authorities towards several complex transactions undertaken by multinationals, an advance pricing agreement (APA) programme has clearly been the need of the hour for multinationals in India. APAs appear to be the best possible solution for obtaining stability and certainty in transfer pricing matters. The APA programme is expected to introduce a whole new dimension to the transfer pricing landscape in India. With taxpayers looking for increased tax certainty, many are opting for the APA route.

APAs were first showcased as a part of the proposed Direct Taxes Code back in 2009 and were again mentioned in the Direct Taxes Code 2010. However, with the uncertainty surrounding the introduction of the Direct Taxes Code, the introduction of APAs was also deferred. For the highly litigious transfer pricing regime in India, this uncertainty regarding the fate of APAs raised much concern amongst large taxpayers. In a much appreciated move, the Ministry of Finance introduced APAs in the Finance Act 2012.

An APA is an agreement between the tax authorities and the taxpayer that determines in advance the most appropriate transfer pricing methodology or the arm’s length price for covered intercompany international transactions. The Indian APA regime allows multinationals to ascertain the potential price for their international transactions beforehand. Taxpayers are also relieved of many compliance obligations for a period of five years, providing taxpayers with stability and certainty with regard to their tax liability.

The tax authorities have proved their claim that the APA programme is a big success, by concluding the first number of APAs in just one year since the APA program was introduced in India. India is undoubtedly the first country in the world to achieve this success in the very first year. The tax authorities believe that the APA programme will help to avoid disputes arising from the country’s increasingly aggressive positions on transfer pricing matters.

Most APA requests in India are from companies belonging to the information technology and information technology enabled services (ITeS), automobile, pharmaceuticals and financial sectors, on issues that pertain to captive outsourcing centres, share valuation, the extension of corporate guarantees, royalties, management fees and interest income. These issues have been at the heart of virtually all transfer pricing disputes.

2. The APA Programme

The introduction of the Indian APA programme is a silver lining to the aggressive transfer pricing audit regime in India, and may indeed be a game changer in the Indian transfer pricing landscape. It aims to reduce much litigation time and expense of taxpayers and tax authorities if adopted in the right spirit.

The Indian APA rules are on a par with the APA rules followed in most developed countries. This is a positive step which takes the Indian transfer pricing regime to the next level. The APA mechanism is available to a person who has undertaken an international transaction, or is contemplating one. The APA will be entered into by the Central Board of Direct Taxes (CBDT) with the taxpayer, after its approval by the central government.

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1. Financial Express (10 March 2014).
2.1. Types of APA

The India APA programme offers three types of APAs, namely unilateral APAs, bilateral APAs and multilateral APAs. A bilateral APA is an agreement between the taxpayer and the CBDT subsequent to and based on an agreement between the competent authorities in India and the competent authorities in the country of the taxpayer’s associated enterprise. A multilateral APA is an agreement between the taxpayer and the CBDT which is neither a bilateral nor a multilateral APA. In a unilateral APA, competent authorities are not involved.

The arm’s length price of an international transaction that may be acceptable to one country may not necessarily be acceptable to the country of the taxpayer’s associated enterprise with which the taxpayer has entered into the transaction. A bilateral or a multilateral APA assures that there is no double taxation of the same income in two jurisdictions. This is why the OECD recommends that wherever possible, an APA be concluded on a bilateral or multilateral basis between competent authorities.

In the APA programme, a mutual agreement procedure (MAP) will not be allowed to resolve transfer pricing disputes under an applicable treaty, where a unilateral APA has been entered into.

2.2. APA application

The APA entered into by a taxpayer and the CBDT may include the international transactions covered in the agreement, the agreed transfer pricing methodology, the determination of the arm’s length price, the definition of any relevant terms, critical assumptions and any conditions to the APA that are not provided in the Income-tax Act 1961 (ITA) or the rules pertaining to APAs.

Prior to filing an APA application, the Rules require mandatory that pre-filing consultations be carried out with the APA team. The option to conduct pre-filing consultations anonymously is also provided. Following the pre-filing consultations, and depending on the outcome, an APA application may be filed, accompanied by the prescribed fee, which ranges from INR 1 million (approximately USD 16,300) to INR 2 million (approximately USD 32,600). The APA filing fee to be paid to the tax authorities depends on the value of the covered international transactions during the term of the APA.

An APA is valid for up to five years, and is binding on both the taxpayer and the CBDT, except when there is a change in any of the terms of the APA. In the latter case, the APA may be revised or even cancelled.

There is no time limit prescribed in the APA scheme for concluding an APA. While one appreciates that another government may be involved in the process (i.e. the competent authorities of the home country of the foreign associated enterprise), prescribing an outer limit would have provided comfort that the process is aimed to be completed in a time-bound manner.

The APA scheme does not contain any safeguards against the sharing of information between the various divisions of the income tax authorities in the event that the taxpayer opts not to proceed with the application.

2.3. Critical assumptions

Critical assumptions are the factors and assumptions which are spelled out in the agreement, and which are so critical and significant that neither party to the agreement would continue to be bound by it if any of these factors or assumptions were to change. Critical assumptions must be “properly worded”, as even a slight change of facts could render an APA unworkable. The taxpayer should evaluate providing possible scenarios to ensure that the critical assumptions clause remains workable.

An APA is not binding on the CBDT or the taxpayer if there is a change in the critical assumptions or if there is a failure to meet any conditions specified in the agreement. Both the CBDT and the taxpayer must give notice in writing to the other party as soon as practicable in the event of any change in the critical assumptions or failure to meet any of the conditions.

2.4. Withdrawal

The taxpayer may withdraw the application for an APA at any time before the finalization of the terms of the APA. No refund of fees will be granted if the application is withdrawn.

2.5. Revision, cancellation and renewal of an APA

The Indian APA mechanism provides for revision in the event of a change in the critical assumptions, a change of law or a request from the other competent authorities for a change in the APA. An APA may be cancelled for failure to comply with the APA terms, failure to file a compliance report, material errors in a compliance report or when the taxpayer does not agree to a revision of the APA. An APA may be renewed after the completion of the term of the APA, without any requirement for a pre-filing consultation.

Unlike international APA programmes, the Indian APA scheme does not allow for rollback provisions. Although there are no provisions for rollback, it is hoped that APAs can exert a persuasive influence on existing litigation and disputes, thereby facilitating the swift resolution of disputes. Now that India has signed its first number of APAs, going forward, the popularity of APAs and their ability to bring about a stable tax regime in India would in some measure be proportional to the ease of the negotiation process and the number of successful APAs that India is able to conclude in a reasonable time frame.
3. The APA Process

3.1. Pre-filing consultation

Pre-filing consultations have been provided for and are mandatory in nature. The pre-filing consultation is useful for discussing the proposed APA with the APA team on a more informal basis, and provides the opportunity for the taxpayer to address particular areas of interest identified by the APA authorities in the final APA submissions. The provision for a pre-filing conference on an anonymous basis could also provide a much-needed opportunity for the taxpayer to determine the receptiveness of the tax authorities to its APA proposal, without fear of inviting an audit. To maintain transparency in the pre-filing process, a “written understanding” is issued to the taxpayer, although this is not required under the rules.

3.2. Main APA application

The application for an APA is to be made to the office of the Director General of Income Tax (International Taxation) (Director General). In the case of a multilateral or bilateral APA, the associated enterprises must also initiate the APA process in their respective countries (with the competent authorities of those countries). The APA application must be filed before the beginning of the financial year with regard to ongoing transactions. With regard to new transactions, the application must be filed before the proposed transactions sought to be covered are undertaken. To screen out the not so serious players, there are graded fees based on the value of the international transactions at issue. The transfer pricing methods to be used to determine the arm’s length price under an APA are those methods referred to in the Indian transfer pricing regulations.

3.3. Site visit

The process and application have been clearly laid out and also allow for visits by the APA team to the business premises of the taxpayer to obtain better practical insight into the function, asset and risk analysis.

3.4. Negotiation with the APA team

The taxpayer must attend meetings with the APA team and answer inquiries, requests and questions from the APA team during the APA process. The taxpayer must engage in negotiations with the APA team. The terms and conditions of the APA need to be reviewed appropriately, and the taxpayer must work with the APA team to finalize the APA.

3.5. Annual compliance

Annual compliance requirements also apply to taxpayers who have entered into an APA. The taxpayer must furnish an annual compliance report. The annual compliance report must be filed within 30 days of the due date for filing the income tax return for that year, or within 90 days of entering into the APA, whichever is later. The transfer pricing authorities must furnish the annual compliance audit report within six months of the end of the month in which it is received by them. Regular transfer pricing assessments will not to be undertaken for transactions covered by an APA.

4. Administrative Set-Up

The Indian APA programme has provided for a dedicated APA team that negotiates APAs, as well as reviews APA documentation submitted by taxpayers. The APA team ensures consistency in the interpretation of the critical assumptions of the APA, and thus enhances effectiveness. The APA team is proposed to include experts in economics, statistics and law who are nominated by the Director General whenever they are required. The present administrative structure of the APA team, comprising hand-picked officers, indicates that perhaps the APA process would not replicate previous audit experiences.

Each tax administration involved in the APA generally monitors compliance with the APA. First, it may require that the taxpayer file annual compliance reports demonstrating (i) the extent of its compliance with the terms and conditions of the APA and (ii) that critical assumptions remain relevant. Second, the tax administration may continue to examine the taxpayer as part of the regular audit cycle, but without re-evaluating the methodology.

5. Practical Considerations and Progress

The APA programme was introduced in 2012. India is one of the few countries where the tax authorities have received more than 375 applications in the initial two years of introduction of APA program: 146 applications in the first year and 232 in the second. From those 232 APA applications, 206 were requests for unilateral APAs and 26 for bilateral APAs. Large US multinationals and Fortune 100 companies were part of the initial group of companies to participate in the India APA programme.

Mr Akhilesh Ranjan, the competent authority of India, has requested that taxpayers place trust in the hard work that the APA team is doing. It is due to mutual trust that the APA team can build upon the programme, such as with regard to APAs, MAP resolutions, safe harbour rules and eventually arrive at a situation where taxpayers truly feel that they can be certain regarding their tax liability in India.4

5.1. Site visits: 85 and increasing

When the APA programme commenced, the APA team decided to place a special emphasis on site visits. As there is much ongoing dispute in the courts and under MAPs, site visits have become necessary to understand the functions that are performed by taxpayers in India. And understanding the functions in turn helps in agreeing on the appropriate economic analysis undertaken by taxpayers.

Site visits are not akin to search/survey as understood under the ITA and are not intrusive. The APA team agrees

4 Transcript of excerpts from the panel discussion of KPMG’s webinar initiated with the Indian competent authority and the Commissioner of Advance Pricing Agreements (19 Dec. 2013).
beforehand with the taxpayer as to the date and time for the site visit. While site visits are not mandatory – and indeed in certain types of transactions (e.g. corporate guarantees), may not be required, such visits facilitate a better understanding of the facts. So far, the APA team has completed 85 site visits out of 146 applications filed in the first round.

5.2. Safe harbour: Not binding

Safe harbour margins are recommended by a committee of experts set up by the Indian government. A safe harbour is a convenience price for the taxpayer, as it relieves the taxpayer from compliance and audit burdens. These margins are not arm’s length margins and are not binding on either the transfer pricing authorities or the APA team. The APA team performs the economic analysis independently without looking at the margins provided under a safe harbour.

5.3. Bilateral APA: Absence of article 9(2)

Under an earlier position of the tax authorities, the presence of an article similar to article 9(2) of the OECD Model in the applicable tax treaty was essential for resolving a dispute. This is India’s stated position with regard to MAPs involving transfer pricing disputes. The same principle has been adopted for the APA programme. The position of the Indian competent authority is that the absence of article 9(2) should not impact an APA which relates to future years and not to past disputes. The competent authority and the APA team are attempting to reconsider the present position and are holding wide-ranging discussions on this issue. The outcome of these discussions is likely to be known in about a month or so.5

5.4. Location savings

The economic forces of globalization have led multinationals to set up shop in low-cost jurisdictions. The tax authorities are challenging that the economic benefit from shifting business to a low-cost jurisdiction should accrue to the source country where the operations are undertaken. The determination and allocation of location savings between group companies has emerged as a key transfer pricing issue in India. India is known for its low-cost resources to provide a quality outcome. Location savings will impact the companies having operations in India. Under Indian tax law, independent comparables are to be relied upon in the economic analysis. Thus, when an associated enterprise in India is being benchmarked against local economic comparables, these are companies operating in the same economic environment using the same resources, having different functions, assets, risks, but fundamentally the economic results are very similar.

Also during the negotiation phase, the APA team attempts to understand the point of differences with the taxpayer and what the taxpayer’s legitimate expectations. The APA team has positively resolved two cases where location savings constituted a factor, and the authors understand that the team has a more pragmatic and practical approach.

5.5. Dialogue with US competent authorities

While bilateral discussions between India and the United States did not take place for quite some time, talks between the Indian and US competent authorities are now back on track after a gap of eight months. The US competent authority met with the Indian competent authority in February 2014. Discussions between the two competent authorities have been very encouraging, in that they discussed tax disputes between the two countries and the nature of those disputes, and also came to an agreed roadmap of how to deal with an inventory of tax disputes. The conciliatory moves have raised hopes of expeditious settlement of long-pending tax disputes involving a number of US multinationals in India, helping India send a signal of its non-adversarial tax regime and friendly investment climate. There are approximately 200 pending MAP cases with the United States, and both of the competent authorities have agreed to four to six meetings in the next year to clear the inventory of cases. They are expected to meet again very soon and it is hoped that at least a few cases will be resolved very soon. The competent authorities of India and the United Kingdom are also likely to meet next month to discuss the proceeding of the bilateral India-UK APAs.

5.6. First APAs in the first year

The CBDT has concluded the first entry of APAs in the first year of the programme’s introduction and thus has paved the path for dealing with the increasing number of transfer pricing disputes. This success is definitely important for building foreign investors’ confidence in the Indian tax system. The CBDT has inked five unilateral APAs in March 2014. These APAs are signed for companies operating in diverse sectors, but not for companies operating in the technology sector. The APA team is working on agreements for the technology sector, which is expected to be concluded in August/September 2014.

As this was the first year of the program, the APA team had to follow certain procedures for the first time. The initial few APAs have been vetted by the Law Ministry as well. Also, negotiation has not been a part of the Indian tax administration, unlike in other countries where in addition to APAs, tax authorities engage in negotiations with taxpayers. Despite all these teething issues, the APA team has managed to roll out the first APAs in the first year. After going through the above processes, the APA team has become familiar with the proceedings, so that the imminent APAs are expected to be dealt with in much less time. The first year of the programme clearly showcased the competence, fairness and unbiased approach of the Indian revenue department.
5.7. Understanding reached in case of share valuation

In what could be indicative of a trend, as well as a way out from tax litigation for many multinationals, the APA team has reached an understanding with a taxpayer on a proposed share issue transaction. The taxpayer and APA team agreed on the price at which the shares will be issued to the parent company of the multinational by its Indian subsidiary. However, an APA has not been signed with the taxpayer, as agreement on other transactions is pending. One of the senior officials clarified that even if the APA for other transactions fails, the taxpayer can still sign an APA with regard to the issue of share valuation. The use of discounted cash flow valuation is one of the suggested approaches to price determination. According to the understanding, these shares must be issued at the agreed price within the next six months, and the APA team is endeavouring to complete the APA process for share transactions within that time frame. This is significant because the issue of share valuation has become contentious and has reached the courts. Indeed, companies like Shell are facing multi-billion dollar adjustments on the share valuation issue.

5.8. Acceptance of true-ups

A taxpayer entering into an APA for a particular cost-plus margin may, at the end of a particular period, perform a true-up to the extent of the margins agreed in the APA if the agreed margins are not achieved. The APA team is open to such pay-ins and pay-outs, where a profitability percentage is agreed with taxpayers and there is a shortfall or excess in the actual numbers. The impact under other laws (e.g. service tax, exchange controls) must be examined.

The other solution which could come to mind is that is adequate to simply reflect this fact in the return and pay tax on the deficit amount. In such a case, if the taxpayer is a captive service provider which, at the end of each month, must compute the costs incurred and add the agreed markup thereon, it may not be possible to perform such kind of adjustment in the return. However, if the taxpayer is engaged in an entrepreneurial activity, these things could be discussed and negotiated with the APA team before finalization of the APA.

6. Conclusion

The introduction of the APA programme and its remarkable progress is testimony to the efforts of the Indian tax authorities to create a hassle-free tax environment in India. At the same time, the Indian tax authorities are responsible for protecting against profit erosion from the country. APAs offer better assurance regarding the taxpayer’s transfer pricing method. Another effect is that they reduce risk and assist in the financial reporting of possible tax liabilities. APAs also decrease the incidence of double taxation and costs linked with audit defence and transfer pricing documentation preparation. APAs can provide risk management, certainty, avoidance of double taxation and reduced litigation. The bilateral or multilateral approach is far more likely to ensure that the APA will reduce the risk of double taxation.

However, a significant challenge of an APA is that it relies on predictions about future events. Critical assumptions should provide possible scenarios and should be appropriately worded to ensure that an APA remains workable. The tax authorities may become privy to highly sensitive information and documentation which could present its own challenges. Further, the taxpayers also need to have assurance that past closed years will not be reopened for an audit based on the transfer pricing agreed in the APA.

The success of the APA programme will be determined by its ability to distinguish itself from traditional audits, and to act as a means to facilitate expedited dispute resolution for international transactions. An APA is certainly a positive step towards a more certain economy; however it is imperative for taxpayers to perform a cost-benefit analysis of all aspects before taking a step forward towards an APA.

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