

# Advance Pricing Agreements (APA)

*A welcome step in transfer pricing disputes*

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## Introduction

In an environment where the government has been trying to attract multinational enterprises to 'Make in India', it is time to introduce initiatives or measures to signal a clear focus on making doing business in India easier. One such initiative has been the introduction of APA programme. Tax authorities in India have become increasingly proactive and vigilant while scrutinizing multinational company transfer pricing with Indian affiliates and correspondingly increasing the intensity of audits.

The domestic appeal and dispute resolution process in India is slow and very time consuming. Therefore, the need for an alternative dispute resolution mechanism such as the Advance Pricing Agreement (APA) program, which provides a proactive opportunity for taxpayers to not only prevent future tax controversies but also to provide a rational basis for settling past disputes where an APA outcome may have a significant persuasive value.

Advance Pricing Agreement (APA) provisions were introduced in the Income-tax Act, 1961 (Act) w.e.f. 1 July 2012. The rules in respect of the APA scheme have been notified by the Central Board of Direct Taxes (CBDT) by way of insertion of Rule 10F to Rule 10T and Rule 44GA in the Income-tax Rules, 1962 (Rules).

The various aspects of rules/ guidelines governing APA and certain operational matters relating to APA are analysed below:



## What is an Advance Pricing Agreement (APA)?

An APA is an agreement between a tax payer and tax authority determining the transfer pricing methodology for pricing the tax payer's international transactions with its associated enterprises (AE's) for future years. The methodology is to be applied for a certain period of time based on the fulfillment of certain terms and conditions. These programmes are designed to help taxpayers voluntarily resolve actual or potential transfer pricing disputes in a proactive, cooperative manner, as an alternative to the traditional examination process.

An APA offers a company several other benefits. It provides greater certainty on the transfer pricing method adopted, mitigating the possibility of disputes and facilitating the financial reporting of potential tax liabilities. Importantly, an APA also reduces the incidence of double taxation, and the costs associated with both audit defense and documentation preparation.

An APA defines the arm's length price for a covered transaction. It is binding on the person in whose case the agreement has been entered into and on the Commissioner and the income-tax authorities subordinate to him [Direct Taxes Code (the 'DTC', Sec. 118(5))] unless there is a change in law or facts relating to the agreement.

At present, a parallel mechanism exists i.e. advance rulings from the Authority for Advance Rulings (AAR). AAR is empowered to examine a prospective contract of a resident taxpayer with a non-resident in order to determine the taxability thereof. The main difference is that under the APA scheme, the tax authorities may determine/quantify the value of the international transaction or profits, whereas the Authority for Advance Rulings does not have a power to do so.

In India, the Board limits the term of an APA to five years (DTC, Sec. 118(4)), as in China (3-5 years; (Implementation Measures of Special Tax Adjustments (Trial Version)[ the 'IMSTA'], Chapter 6, Article 49), rather than establish an expected minimum term, as in the United States (5 years; Revenue Procedure 2006-9 [the 'RP'], Sec. 4.07). Flexibility in the number of years may be a particularly important feature at the launch of an APA program, as APAs with long terms are sometimes necessary to accommodate a business cycle for a particular taxpayer, or for other reasons.



## What are the different types of APAs?

An APA can be unilateral, bilateral, or multilateral.

- **Unilateral APA:** an APA that involves only the tax payer and the tax authority of the country where the tax payer is located.
- **Bilateral APA (BAPA):** an APA that involves the tax payer, associated enterprise (AE) of the tax payer in the foreign country, tax authority of the country where the tax payer is located, and the foreign tax authority.
- **Multilateral APA (MAPA):** an APA that involves the tax payer, two or more AEs of the tax payer in different foreign countries, tax authority of the country where the tax payer is located, and the tax authorities of AEs.

## Some areas of prolific transfer pricing disputes where APA is likely to be useful:

- Business restructuring transactions
- Captive intra-group services
- Payments for use in intellectual property
- Agency services or commission agents
- Sales supply chain structures
- Procurement services and sales support services
- Limited risk distributors
- Allocation of headquarter and management fee
- Financial transactions such as loans and guarantees
- Commodity trading
- Low margin companies with significant inter-company transactions
- Contract manufacturing



## International Scenario

Country	Year of introduction	Type of APA	Term of agreement	Pre-filing
Japan	1987	Unilateral & Bilateral	3-5 years	Optional
USA	1991	Unilateral, Bilateral & Multilateral	3-5 years	Mandatory
UK	1999	Unilateral, Bilateral (No distinction in bi and multilateral)	18 to 21 months	Optional
China	2004	Unilateral, Bilateral & Multilateral	3-5 years	Mandatory
India	2012	Unilateral, Bilateral & Multilateral	Upto 5 years	Mandatory

## What are the key benefits of APA?

An APA provides the following benefits:

- Certainty with respect to tax outcome of the tax payer's international transactions, by agreeing in advance the arm's length pricing or pricing methodology(ies) to be applied to the tax payer's international transactions covered by the APA;
- Substantial reduction of compliance costs over the term of the APA; and
- For tax authorities, an APA reduces cost of administration and also frees scarce resources. Consequently, APAs provide a win-win situation for all the stakeholders involved.
- Removal of an audit threat (minimize rigours of audit), and deliverance of a particular tax outcome based on the terms of the agreement.



## Who is eligible to file for an APA?

Any tax payer who has undertaken an international transaction or is contemplating to undertake an international transaction is eligible to file for an APA.

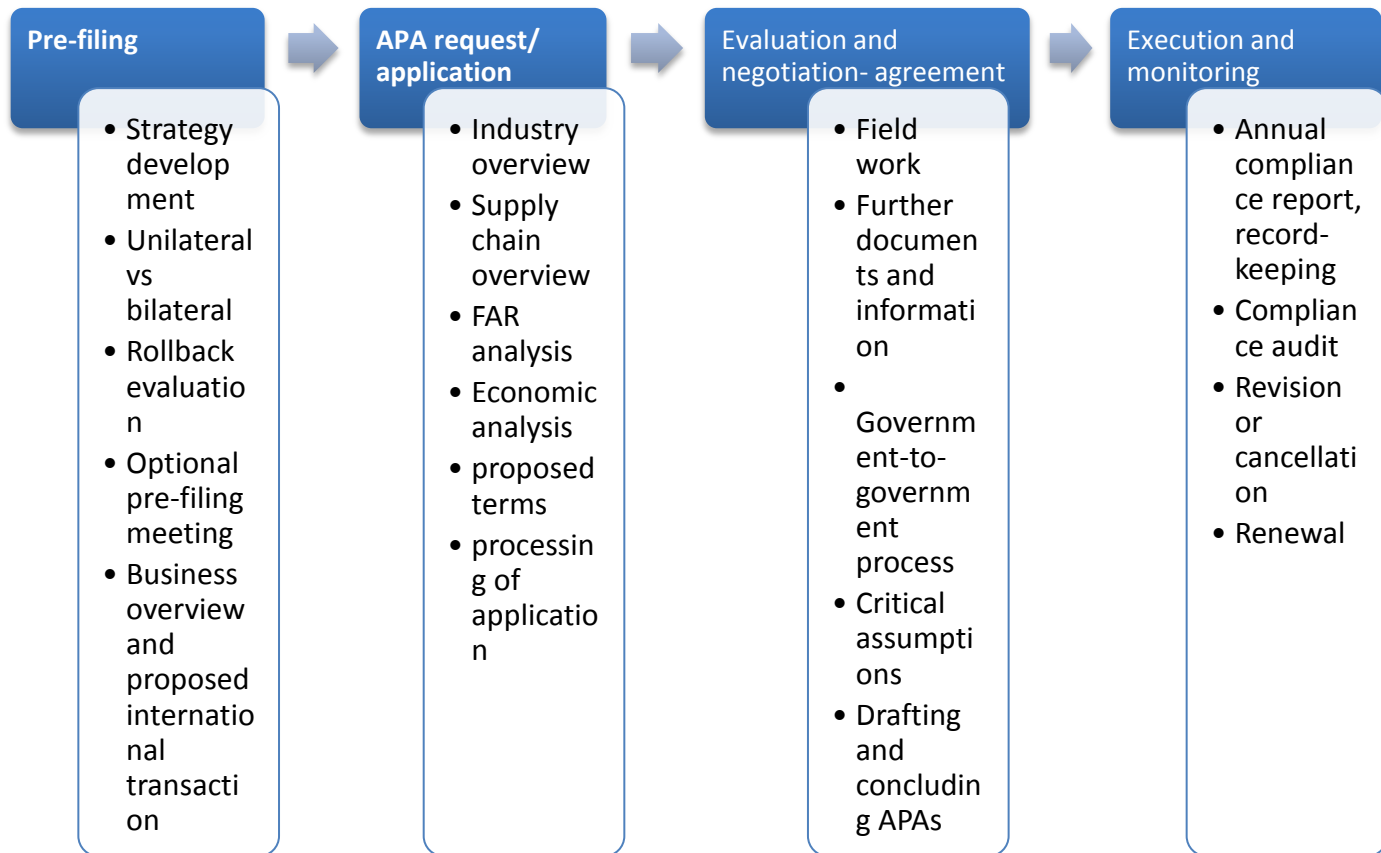
## Do the APA rules prescribe any criteria for accepting an APA?

There are no monetary limits or other prescribed criteria for a tax payer to be eligible for applying for an APA.

## Can tax payers opt to cover some of the several international transactions in an APA?

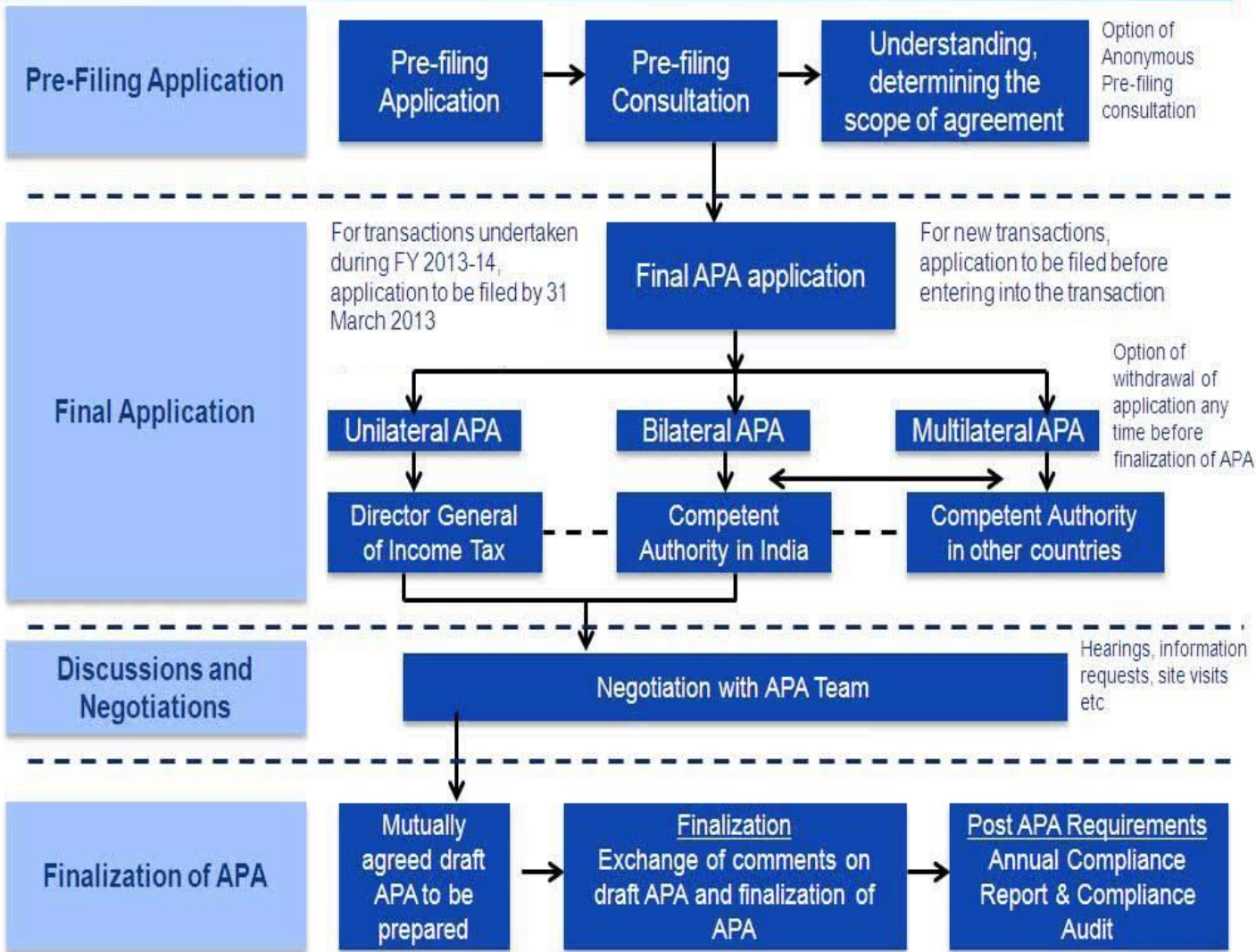
Yes, the taxpayers have the option covering all or some of the international transactions in an APA.

## APA Process- An Overview





## APA - Process



## Pre-filing consultation

The APA Rules provide for a preliminary consultation before formally lodging an APA application. In such consultation, the tax payer and the APA team will discuss and clarify the scope of the APA, the transfer pricing issues involved and whether an APA can be executed or not. The pre-filing consultation is **mandatory**, and specified information has to be filed as part of the pre-filing application to Director General of Income Tax (DGIT) in **form 3CEC**. However, the discussion during the pre-filing meeting is not binding on either the tax payer or the tax authorities.

Pre-filing conferences can be held on a **named or anonymous basis**. Particularly in the beginning of the program, it would be useful if taxpayers are given an opportunity to meet the Board personnel, who will process their case. This will help build trust in the process. In particular, offering anonymous pre-filing conferences provides taxpayers the opportunity to determine the receptivity of the Board to the issues in its particular case without fear of inviting an audit or identifying possible areas of audit, should the taxpayer decide not to proceed with an APA.

## Can tax authorities reject any APA application based on the outcome of the pre-filing discussions?

The pre-filing consultation would not bind the CBDT or the tax payer to either initiate the APA process or to enter into an APA. However, it may be possible that in a pre-filing meeting the authorities may indicate their reluctance to accept the proposed methodology which could influence the negotiation process. It is expected that that understanding reached at this stage will be communicated in writing.



## Application for APA

An application for a unilateral agreement should be made to the Director General of Income Tax (international taxation) (DG-IT). For BAPA/MAPA, application should be made to the Competent Authority (CA) in India. The CA will send the application to DG-IT who in turn will send it to respective APA teams.

In the case of BAPA/MAPA, negotiations between the CAs of India and other country (ies) shall be carried out in accordance with the provisions of the tax treaties. Further, the process in India will be initiated, only after filing the application with the CAs in the AEs' jurisdiction and evidence to that effect is provided to the Indian CA.

An APA application is required to be accompanied with the filing fees as below:



Amount of International Transaction entered into or proposed to be undertaken in respect of which agreement is proposed during the proposed period of agreement	Fee (INR)
Amount not exceeding Rs. 1 billion	1 million
Amount not exceeding Rs. 2 billion	1.5 million
Amount exceeding Rs. 2 billion	2 million

## Preliminary processing and procedure

It includes vetting the application for any deficiencies. If the application is allowed in the preliminary processing phase, the main processing of applications would be conducted by the APA team in the following manner:

- holding meetings with applicant
- calling for additional documents/information/material from the applicant
- visiting applicant's business premises
- making inquiries as may deems fit in the circumstances of the case

## Agreement and terms

APA requires approval of the Central Government. It should include international transactions covered, agreed methodology, Arm's Length Price if any, critical assumptions, time period, definition of terms and other conditions if not covered in the prescribed APA scheme.

## Annual Compliance Report

Compliance report shall be filed annually as below:

- **Form 3CEF** to be furnished in quadruplicate to DGIT for each of the years covered in the agreement
- One copy each would be sent by the DGIT to the CA India, to the jurisdictional CIT and one copy to the TPO
- To be filed within thirty days of the due date of filing the income tax return for that year, or within ninety days of entering into an agreement, whichever is later

## Withdrawal

If any defect is noticed in the application filed by the applicant following a successful pre-filing consultation and if the application is withdrawn at this stage, then the fee paid by the applicant shall be refunded. Further, the tax payer may withdraw an application at any time before its finalization, by filing a request in a prescribed **Form 3CEE**. However, in case of such withdrawal, the tax payer would not be eligible for receiving a refund of filing fee. The procedure is no different for BAPA/MAPA.

## Cancellation

The CBDT has the powers to cancel an APA if the results of the compliance audit indicate that: • the applicant has failed to comply with the terms of the agreement, • there is a failure to file the annual compliance report within the stipulated timeline, • there are material errors in the annual compliance report filed by the applicant, or • if the applicant is in disagreement with the proposed revision in the APA. If an agreement is cancelled based on the discovery of fraud or misrepresentation of facts on the part of the applicant the same shall be deemed cancelled ab-initio and audit will take place accordingly.

## Renewal

In case of renewal of an agreement, all the procedures other than the pre-filing procedures will be followed by the applicant treating the application at par with a new applicant. It is expected that where the circumstances do not change materially getting a renewal of an APA would be a lot easier than getting an APA for the first time. Renewed APA can be on new terms depending on the facts of the case.

## Revision of an APA

An APA can be revised in case of change in critical underlying assumptions, change in such law other than that which renders it non-binding or on request from CA in the other country. The revision order is required to be in writing citing reasons of revision required and revisions can be initiated by the Board / DGIT/ CA/ taxpayer. Opportunity of being heard shall be provided and non-agreement by the taxpayer on the proposed revisions may result in cancellation of the APA.

## Rollback provision

The recently notified APA Rollback rules also provide an option to the taxpayer to roll back the APA for prior four years to the same international transaction, subject to certain conditions. Thus, based on the amendment, an APA could be made applicable for five prospective years as well as the immediately preceding four years, thereby providing certainty to the taxpayer for a maximum period of nine years

Conditions applicable for availing rollback provisions, as notified by the CBDT, are:

- (a) the international transaction must be the same as the one to which the APA is applicable;
- (b) the return of income for the relevant rollback year has been filed;
- (c) the report in respect of the international transaction has been furnished as required under Section 92E;
- (d) the rollback is requested for all rollback years in which the international transaction has taken place; and
- (e) the application has been made in the prescribed format of Form 3CEDA.



## Safe Harbour Rules

To reduce increasing number of transfer pricing audits and prolonged disputes, the Central Board of Direct Taxes (CBDT) had issued the draft Safe Harbour rules (SHR) on 14 August 2013, inviting public comments. SHRs are applicable for a period of 5 years starting with Financial Year 2012-13 for the prescribed sectors. The option of being governed by SHRs shall continue to remain in force for the period specified by the taxpayer in the prescribed form (Form No. 3CEFA) or a period of five years whichever is less.

The notification of the safe harbour rules is a welcome development and yet another conciliatory step towards minimising transfer pricing disputes and improving the overall investment climate in India from a tax perspective. Safe harbours are generally considered incompatible with the arm's length principle. However, even internationally, safe harbours rules have been evaluated favourably where the benefits of simplified transfer pricing compliance and administration outweigh the possible concerns. Therefore, the safe harbour regime to successfully work in India would need effective implementation measures by the tax department.

This is to ensure that the primary objective for introduction of safe harbours, which is reduction in transfer pricing litigation and related uncertainty, is effectively achieved. Larger captive players may still not find the revised Safe Harbour rates lucrative enough to opt for the same. In such cases, opting for an Advance Pricing Agreement (APA), which could result in closer approximation of the arm's length price, may be rather preferable option. While bilateral APAs would completely mitigate the risk of double taxation, a tax payer opting for safe harbour rules will not be able to avoid possibility of economic double taxation.

### New Delhi:

S-13, St. Soldier Tower, G-Block  
Commercial Complex, Vikas Puri,  
New Delhi - 110018

Phone : + 91 11 28543739  
: + 91 11 28544939  
: +91 11 45527239  
Fax : +91 11 43850030

### Gurgaon:

1156, Tower B2, 11th Floor, Spaze  
i- Tech Park, Sohna Road,  
Sector 49, Gurgaon-122001

Phone : +91 124 4371317  
: + 91 124 4371318  
Fax : +91 11 43850030

### Mumbai:

Unit No.3, 1st Floor, New  
Laxmi Shopping Centre, A-Wing,  
H.D.Road, Ghatkopar (W),  
Mumbai - 400086 (India)

Phone : + 91 98202-63544  
: + 91 22-25110016

E-mail : [info@neerajbhagat.com](mailto:info@neerajbhagat.com)  
Web site : [www.neerajbhagat.com](http://www.neerajbhagat.com)

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Neeraj Bhagat is a member of the Institute of Chartered Accountants of India (ICAI) since 1997. He is also an Associate member of Association of International Accountants, United Kingdom. He is founder of Neeraj Bhagat & Co, an Indian Chartered Accountancy firm serving various MNC'S from across the globe. Neeraj Bhagat & Co. has its offices at New Delhi, Gurgaon and Mumbai. They are part of Allinial Global Accounting Association which is one of the World's Top 10 in accounting associations.