

India

Advance Pricing Agreement – Indian Experience

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India introduced advance pricing agreement provisions in its domestic law in the year 2012. In this article, the author has critically examined the role of the programme in changing the transfer pricing litigation landscape in the country and has considered the usefulness of the programme for developing countries.

1. Introduction

From 1 April 2001, a separate code on transfer pricing under sections 92 to 92F of the Income Tax Act 1961 (ITA), based on the arm's length principle, covering intra-group cross-border transactions became applicable in India.

With this introduction, India created separate transfer pricing directorates staffed with dedicated officers to implement the transfer pricing provisions. Years of transfer pricing audits had resulted in a large number of disputes, a majority of which were due to transfer pricing adjustments. The transfer pricing disputes moved from one administrative and judicial authority^[1] to another, without any final resolution, because these disputes are issues of facts rather than questions of law. The dispute resolution process was never-ending and consumed a lot of resources and time of tax authorities, taxpayers and appellate authorities. A need was felt for an alternate and effective dispute resolution mechanism to bring about tax certainty and uniformity of approach on the transfer pricing issues.

A large inventory of disputes led to the legislation of safe harbour rules in the year 2009, but these rules did not meet the expectation of the taxpayers, and only a few taxpayers opted for these rules.

Against this backdrop, the advance pricing agreement (APA) programme was introduced in the ITA in the year 2012. The provisions regarding the rollback of the APA were enacted later in the year 2015. The APA process is voluntary, and it supplements appeal and other dispute resolution measures provided in the ITA and the mutual agreement procedure in the double taxation avoidance agreements for resolving transfer pricing disputes.

After briefly discussing the salient features of the Indian APA programme, this article critically examines the achievements of the APA programme in preventing and resolving transfer pricing disputes in India. Before concluding, a case for the suitability of the APA programme for developing countries is made.

2. APA Programme – Salient Features

The basic rules of the Indian APA programme^[2] are no different from that of other countries that have implemented similar programmes. The Finance Act 2012 inserted sections 92CC and 92 CD in the ITA to provide the legal basis for APA in India. These statutory provisions, effective from 1 July 2012, empowered the CBDT to enter an agreement with any person determining the arm's length price (ALP) or specifying the manner of determination of ALP of an international transaction to be entered into by that person.

The rules regarding the implementation of the APA Scheme were notified later on 30 August 2012 in the form of rules 10F to 10T and rule 44GA of the Rules. These provisions lay down the detailed procedures for the furnishing of pre-filing consultation application, pre-filing consultation, fees, filing of APA application, processing of application, amendment of application, withdrawal of application, terms, and conditions, filing of Annual Compliance Report, Compliance Audit, revision, cancellation, and renewal of the APA. The CBDT subsequently issued a "Guidance with FAQs" on the APA scheme in the form of a Tax Payer Information Series.^[3] A taxpayer can request an APA for a maximum period of five years.

Rollback provisions in the APA scheme were introduced by the Finance (No. 2) Act 2014. The relevant rules (10MA and 10RA) for the rollback of the APA were notified on 14 March 2015, and a FAQ^[4] was issued explaining the provisions of the rollback of the APA. The

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1. The Supreme Court, the High Courts, the Income Tax Appellate Tribunals, Dispute Resolution Panel, and Commissioner of Income Tax (Appeals).

2. These rules can also be found on the Tax Research Platform of the IBFD on <https://research.ibfd.org/#/>.

3. Guidance and FAQs available at [http://www.incometaxindia.gov.in/booklets%20%20pamphlets/advance-pricing-agreement-guidance-with-faqs-\(tpi-43\).pdf](http://www.incometaxindia.gov.in/booklets%20%20pamphlets/advance-pricing-agreement-guidance-with-faqs-(tpi-43).pdf) (accessed 1 Oct. 2019).

4. Circular No. 10/2015 dated 10 June 2015 is available at http://www.incometaxindia.gov.in/communications/circular/circular_no_10_2015.pdf (accessed 1 Oct. 2019).

rollback provisions are applicable for four years prior to the first year of the APA period, and the applicant does not have the option to pick and choose the years for which it wants to apply for rollback. The applicant must either apply the rollback of the APA for all four years or not apply it at all. For example, if the applicant's transfer price has been accepted to be at arm's length in the transfer pricing audit in any of the four previous years or a year is not in the transfer pricing audit, these years cannot be left out, and the rollback of the APA would apply to these years as well. The Indian transfer pricing regulation⁵ has introduced provisions regarding secondary adjustment, and these also apply to adjustments arising out of APAs. The APA remains in force for the period covered in the APA and is binding on the taxpayer and the Commissioner of Income Tax (and his subordinate income tax authorities) having jurisdiction over such taxpayer.

The Indian APA programme provides for unilateral, bilateral, and multilateral APAs. The applicant has the option of choosing a particular type of APA. A unilateral APA⁶ is an agreement between the CBDT and the applicant and protects the applicant from transfer pricing adjustments under the ITA. In the bilateral APA, the applicant is required to make an application with the Indian competent authority, and another request is needed to be made by the applicant or its AE to the competent authority of its country of residence. The bilateral and multilateral APAs protect the taxpayers and their associated enterprises from the potential double taxation of the income from the same international transaction. The provisions of mutual agreement procedure (article 25 or equivalent) and associated enterprises (article 9) of the relevant tax treaty are used to negotiate and agree at the bilateral and multilateral APAs with the tax authorities of other countries. The applicant must accept the agreement negotiated by the competent authorities before a bilateral or multilateral APA is signed.

APA rules do not provide for the suspension of the ongoing transfer pricing audit during the processing of the application and until the signing of the agreement. The taxpayer is protected from the transfer pricing audit for the covered transactions after signing the agreement.

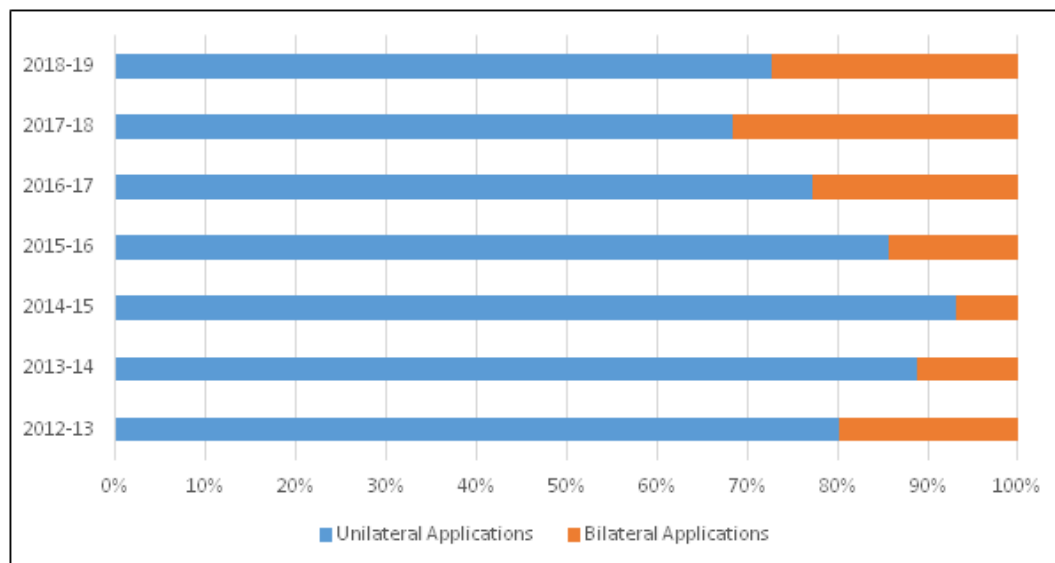
The government has created dedicated teams in the administrative setup and the CBDT to handle APA cases exclusively. The APA Teams in the field formation are responsible for processing both unilateral and bilateral applications and submit its report (Position Papers) to the CBDT. After approval of the CBDT, the APA Team negotiates the terms and conditions with the taxpayer in the case of a unilateral APA. In the case of applications for bilateral/multilateral APAs, the competent authority of India carries out negotiations with the competent authorities of other countries.

3. Performance Analysis

Applications for APAs were accepted for the first time in the year 2012/2013. This means that currently, seven cycles of application filings have been completed – see [Figure 1](#).

There has been an overwhelming response to the programme from the taxpayers. The data on year-wise applications filed in [Figure 2](#) demonstrates the continued interest of the taxpayers in the programme.

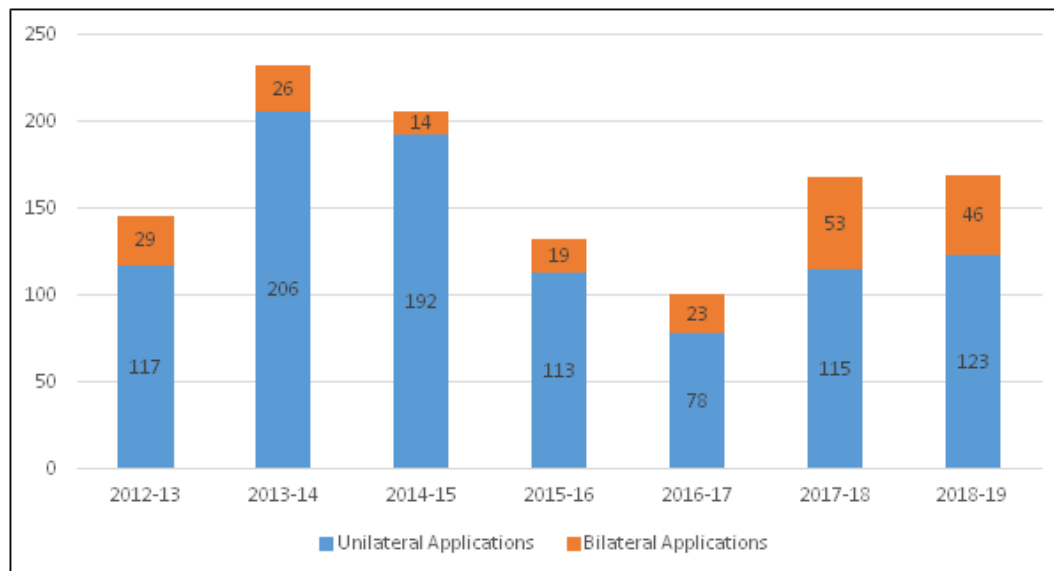
Figure 1 – Composition of UAPA & BAPA for various FYs



5. See sec. 92CE ITA.

6. In unilateral APAs, the risk of potential double taxation remains given that the methodology agreed by the taxpayer with the tax administration of a country may not necessarily be accepted by the counterparty tax administration. This risk may increase after the unilateral APAs are exchanged with the tax administration of the counterparty based on the minimum agreed standards in relation to Action 5 of the G20/OECD BEPS Project.

Figure 2 – Chart depicting total number of APA applications received and the break-up into unilateral & bilateral applications



Significant developments have been noticed since the beginning of the programme. First of these changes is the preference for bilateral APAs by large MNE groups having complex international transactions. In the first year 2012/2013, the majority of the applications were for unilateral APAs. In the year 2017/2018, bilateral applications filed were more than double of those applied in the year 2016/2017. The applications for bilateral APAs were 32% of the total applications received in the year 2017/2018. During the year 2018/2019 this percentage was 28%. The surge in applications for bilateral APA is due to several reasons, including the decision of the US competent authority to open the APA programme with India from February 2016. The opening of bilateral APAs by India with other major trading partners like the Republic of Korea and Singapore due to the revision of its tax treaties providing for paragraph 2 in article 9 has enabled filing of applications for APAs involving these countries. India has also changed its position on article 9(2) that it will admit applications for bilateral APAs even in the absence of paragraph 2 in article 9 of the tax treaty. Additionally, taxpayers' desire to prevent double taxation continues to be the primary reason.

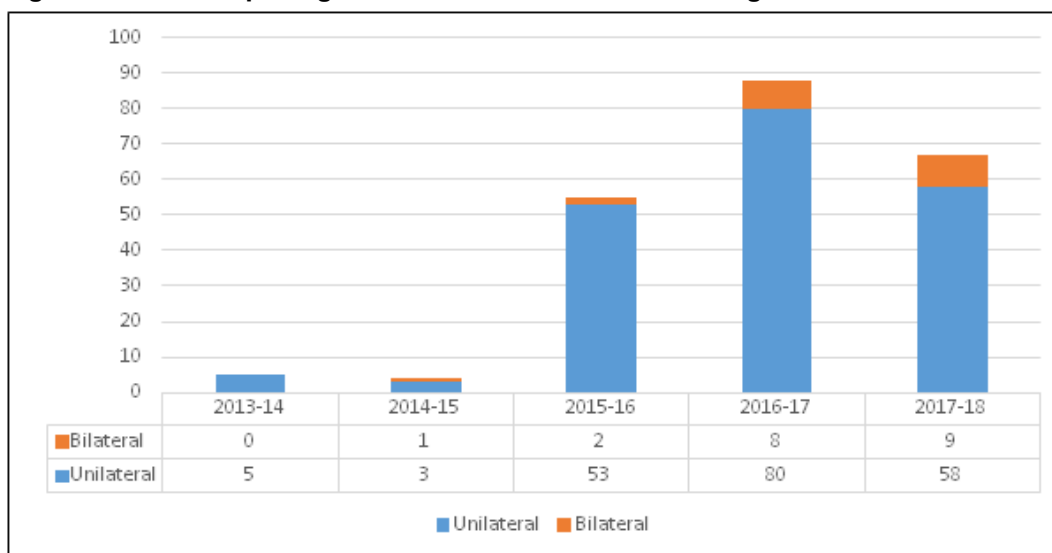
During the year 2018/2019, 45% of the applications filed for unilateral APAs are renewal applications. This seems to indicate that taxpayers are happy with their APAs and wish to renew the same.

The majority of the applications for bilateral APAs are for APAs with the United States, the United Kingdom, Japan, the Netherlands, Sweden, and Australia. The Report of 22 March 2019, issued by the Director, US APMA Program for the calendar year 2018⁷ shows that the United States received 161 applications for bilateral APAs in the year 2018. 21% of these applications were for bilateral APAs with India. The number of applications involving different countries echoes India's trade volumes with these countries.

Implementing an APA programme is not an easy task. It requires dedicated and trained resources to match the expertise and experience available with the taxpayers and their consultants. The processing time of a case depends on the complexity of the case and the availability of resources. Due to these factors, the programme started at a slow pace but gained momentum with the passing time and gaining experience by the processing teams. Figure 3 provides year-wise information on agreements signed.

7. See US APMA Report as of 31 Dec. 2018, available at <https://www.irs.gov/pub/irs-drop/a-19-03.pdf> (accessed 1 Oct. 2019).

Figure 3 – Chart depicting number of UAPAs and BAPAs signed



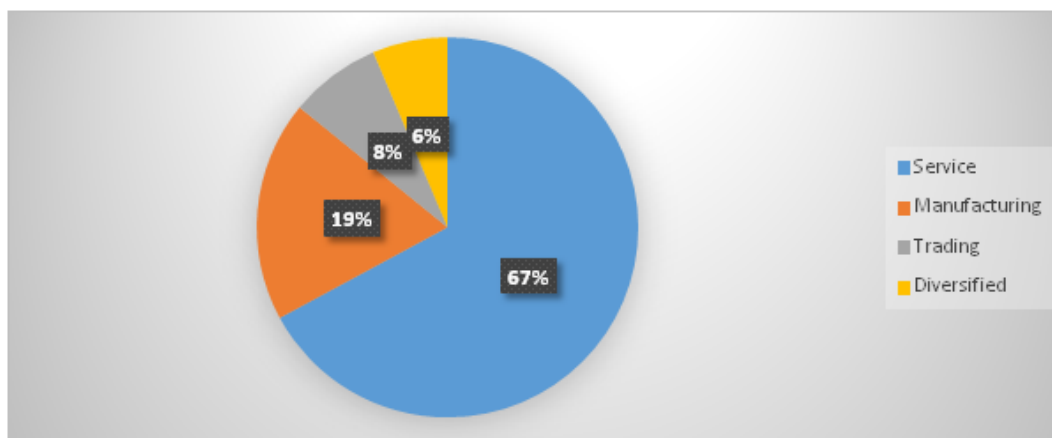
The CBDT has signed 52 agreements in the year 2018/2019, taking the tally of agreements signed to 271 till 31 March 2019.^[8] A significant landmark of signing a total of 300 agreements was achieved on 30 September 2019.^[9]

Another significant element of the programme is taxpayers' desire to seek resolution of pending transfer pricing disputes by opting for a rollback of the APA. Out of 219 taxpayers signing agreements till 31 March 2018, 108 have benefitted from the rollback of the APA.

The applications received during the initial years of the programme mainly belonged to taxpayers having a history of transfer pricing disputes or with complex intra-group transactions. However, many taxpayers have applied for APAs, having no transfer pricing adjustments history.

Figure 4 provides information on the economic activities covered in the agreements signed until 31 March 2018.

Figure 4 – Number of APAs signed



A majority of the APAs signed deal with the transaction of export of services by captive service providers in the country. The export of services includes software development services, IT infrastructure support services, information technology enabled services, and knowledge-based services. Only a few APAs signed currently deal with transactions in intangible property and business restructuring. The data in Figure 4 is consistent with the dominant position India enjoys as a location for the establishment of services sourcing centres by the MNE groups because of the easy availability of vast skilled and experienced human resources, significantly low cost of operation, and benefit of time zones. Additionally, capacity can be quickly ramped up or scaled down due to the availability of human resources and favourable labour laws.

The manufacturing cases involve a wide variety of transactions like import of raw material, the export of semi-finished or finished goods, payment of royalty, and charge for intra-group services. Trading or distribution involves the import of finished goods, marketing, and sales

8. See CBDT Press Release, available at <http://pib.nic.in/newsite/PrintRelease.aspx?relid=189634> (accessed 1 Oct. 2019).

9. See Government of India Press Release, available at <https://pib.gov.in/PressReleaseDetail.aspx?PRID=1586827> (accessed 4 Oct. 2019).

in the domestic market. Some cases concern the provision of marketing support services to the associated enterprise making direct sales to customers in India. Other transactions covered in APAs include that of guarantee fee, interest on external commercial borrowings, research and development services, and management fee.

The Indian law does not give any priority to the utilization of any of the six transfer pricing methods. The nature of the transaction and availability of reliable information on the comparable or other data help in the selection of the most appropriate transfer pricing method. An analysis of agreements signed in the year 2017/2018 shows that the transactional net margin method (TNMM) was used for benchmarking 133 out of 182 transactions. The comparable uncontrolled price method was used in 21 transactions. The “Other Method”^[10] was used in 24 transactions. The cost-plus method was used in three cases, while the internal resale price method was used in only one case. These trends in the use of methods demonstrate the practical difficulties in the application of methods other than TNMM. The Use of CUP is generally limited to benchmarking interest on loan transactions. The application of cost-plus is suitable for contract manufacturing cases. The TNMM finds use in cases of export of services and cases involving multiple and inextricably linked transactions in which separate benchmarking of transactions becomes difficult.

The “Other Method” is not a method prescribed in the OECD TP Guidelines.^[11] This method is increasingly being used in the concluded APAs in India for cases in which the application of the five established methods is difficult for various reasons, for example, cases involving complex transactions or transactions for which comparable data is not available. The non-availability of information on comparable data poses significant difficulty in the application of the arm’s length principle in developing countries.

In the controlled transactions involving the provision of services to the associated enterprises, the TNMM has generally been used as the transfer pricing method, and the operating profit margin (markup on cost) is the standard profit level indicator used to benchmark financial results.

For the application of TNMM in cases of export of services, the constituents of cost base of the service-providing entity in the controlled transaction and the comparable entity should be the same as there is the possibility of differences between the cost bases arising from the use of indirect expenses in the cost base and expenses being borne by the associated enterprise which is not charged to the service provider entity. In the case of captive service providers, it is necessary to determine the proper cost incurred for the application of a markup. The operating cost should include the cost of the employee stock option plan, restricted stock unit, or a similar incentive provided to the employees of the taxpayer in India by the parent group entity. The effect of the use of free of cost assets or assets on loan provided to and used by the taxpayer for the provision of services forms part of the operating cost. The non-allocation of such costs by the associated enterprises results in a narrow cost base of the applicant, and this becomes different from the cost base of comparable independent enterprises in whose case cost base includes all expenses incurred for rendering similar services.

There have been conflicting positions in the transfer pricing audits on whether a foreign associated enterprise can be used as a tested party. In concluded APAs, most have used the Indian applicant as the tested party, but using a foreign associated enterprise as a tested party is not uncommon, and this is consistent with the international practice.

Another bright spot about the APA programme is the interest of taxpayers in seeking renewal of earlier signed agreements. During the financial year 2018/2019, 45% of the applications for unilateral APAs received are for renewal of already signed APAs. Receipt of a large number of renewal applications shows that the taxpayers have benefitted from the programme and they look for a tax regime free from transfer pricing dispute.

4. Observations on the APA Programme and the Way Forward

The Indian APA programme has completed six years of operation. The following paragraphs summarize significant aspects of the programme.

The APA programme has proved to be an exemplary instrument in the hands of the tax administration and taxpayers in solving present transfer pricing disputes, preventing future disputes, and eliminating the risk of transfer pricing audits. The APA programme has created an environment of transparency, good faith and trust.^[12] The taxpayer mitigates actual and potential transfer pricing disputes, and the government protects its tax base and prevents resource-consuming disputes.

The processing of APA cases has helped in the identification of several types of transactions that were not considered as international transactions by the taxpayers. Similarly, the programme has helped in defining the cost base properly in the case of captive service providers and contract manufacturers.

Complex issues can be effectively dealt with in APAs. In an APA evaluation process, significant effort and time are required to understand the allocation of functions and risks amongst the entities undertaking the covered transactions. The tax administration needs to have a

10. The CBDT effective 1 Apr. 2012 had prescribed a sixth method for computation of arm’s length price under sec. 92C of the ITA and Rule 10B of the IT Rules (the other five methods are: comparable uncontrolled price method, resale price method, cost-plus method, profit-split method, and transactional net margin method).

11. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (OECD 2017), Primary Sources IBFD.

12. The Indian APA rules neither derogate from the principles of taxation in the ITA nor confer any selective tax advantage to any taxpayer. The programme does not create any non-competitive tax environment, and there are no issues similar to that of State aid as prescribed in article 107 of the *Treaty on the Functioning of the European Union*, Primary Sources IBFD. (See General Court of the European Union decision in the case of *Luxembourg v. Commission* (T-755/15) and *Fiat Chrysler Finance Europe v. Commission* (T-759/15), available at <http://curia.europa.eu/juris/document/document.jsf?jsessionid=F62826F6DF8AC39ADBC8FED25D2E2E59?text=&docid=218102&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=425410> (accessed 9 Oct. 2019)).

good transfer pricing audit experience before embarking on the APA programme. India already had about ten years of TP audit experience and had skilled and experienced resources available to implement the programme effectively.

It is challenging to implement the arm's length principle in a developing country or an economy in transition for the reasons of shortage or non-availability of independent third parties, or information on comparable uncontrolled transactions. Lack of trained and experienced resources is also a big issue. The information on comparables is crucial to apply all transfer pricing methods except the profit-split method. The specific sectors of business in which MNEs operate in a developing country are mostly dominated by MNEs only, and this makes the task of identifying an independent enterprise or uncontrolled transaction very challenging.^[13] An APA, to a large extent, helps overcome these problems because a solution to the issues can still be found based on facts and circumstances of the case. In a large number of cases, the use of "Other Method," which may involve the use of a combination of methods and several parameters to arrive at a mutually acceptable solution, sometimes becomes a necessity.

The problems due to the asymmetry of information available with the taxpayers and tax administration, as experienced during the transfer pricing audits, can be effectively overcome in the APA proceedings. The taxpayers and the MNE group generally extend full cooperation in furnishing the documents and any other relevant information. The reports on Actions 8 to 10^[14] and 13^[15] of the G20/OECD BEPS Project and changes in the OECD TP Guidelines, especially three-tiered documentation requirements and application of principles of aligning transfer pricing outcome with value creation, are of great help in implementing the APA programme. For example, these documents help in finding an answer to the query: whether the intercompany transfer price setting methodology described in the Local File is consistent with the methodology stipulated in the Master File. The availability of three-tier documentation assists the tax administration in proper economic analysis and decision making.

The conclusion of APAs usually gets expedited in cases of taxpayers presenting high-quality and robust economic analysis consistent with the FAR of the transactions. The deciding factor becomes the level of confidence that the application and behaviour of the taxpayer give to the APA Team. It becomes easy to conclude an APA if the position proposed by the taxpayer is realistic and supported by proper documents and analysis.

Most of the APAs signed are with the taxpayers being subsidiaries of the MNEs located outside India. Some APAs have been signed with Indian MNEs having operations and investments overseas. APA applications from Indian MNEs are likely to increase as more and more Indian companies invest outside India. This development may require more of bilateral APAs with tax authorities of other countries.

The APA removes clouds of uncertainty in transfer pricing issues for the taxpayers and reduces the pressure on the scarce resources of the tax administration. The taxpayer and tax administration are obliged to withdraw pending appeals. The signing of a large number of APAs has considerably reduced the inventory of disputed cases with administrative and judicial authorities, and the positive effect will be more visible in the future. The successful conclusion of APAs in large numbers may reduce work with the regular transfer pricing officers and saving on the resources.

The number of bilateral APAs is likely to increase as MNEs would want to avoid double taxation and ensure tax certainty on the taxation of cross-border transactions in both countries. Another notable development is the increase in the joint site visits by the authorities of both countries, which avoids disagreements on the facts in the cases.

The experience shows that applicants seeking APAs are not only those having present transfer pricing disputes, but many taxpayers with no dispute history have opted to get an assurance on their transfer price and avoid any dispute in the future.

The taxpayers and intermediary service providers have played a very commendable role in APA proceedings, and they do understand the concerns of the tax administrations in particular to documentation, economic analysis, and non-availability of comparable data and supported the willingness of the tax administration in providing a fair and reasonable solution.

The success of any programme depends on how soon the proceedings would come to an end. There is an issue of a large inventory of cases waiting for early disposal and allocation of more resources may be required to ensure the timely conclusion of APAs.

5. Suitability of APA Programme for Developing Countries

Developing countries face several difficulties in implementing the arm's length principle. The tax administration lacks trained and experienced resources and faces challenges due to non-availability of the information on comparable uncontrolled transactions or independent enterprises.

The Indian experience suggests that a country should have a trained workforce and experience of implementing the transfer pricing law before the start of an APA programme. The tax administration should develop capabilities, have access to proper training for its resources, and information on independent enterprises or transactions to match the resources available with the MNE groups.

The APA process allows in-depth understanding of factual aspects of the case and sound knowledge of transfer pricing issues and provides opportunities for the tax administration to learn and apply the transfer pricing law by working in a non-adversarial environment. A

13. United Nations Practical Manual on Transfer Pricing for Developing Countries (UN 2017), available at <https://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf> (accessed 1 Oct. 2019).

14. OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports* (OECD 2015), Primary Sources IBFD.

15. OECD/G20, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13: 2015 Final Report* (5 Oct. 2015), Primary Sources IBFD.

tax administration may implement an APA programme for specific types of transactions, for example, financial transactions, or distribution transactions, or supply of raw materials depending on the nature of the industry in the country. APAs help in finding solutions to transfer pricing issues based on negotiations between tax administrations and taxpayers and may resolve issues which may otherwise demand a lot of resources and time.

After the implementation of the minimum standard on transfer pricing documentation and country-by-country reporting as per Action 13 of the OECD/ G20 BEPS project, the members of the Inclusive Framework on BEPS including developing countries will be able to get the required information on the taxpayer and the MNE group for implementing the transfer pricing law. The potential disputes arising due to the implementation of transfer pricing law can be avoided by devising a well-structured APA programme.

6. Conclusion

The intra-group trade accounts for approximately 50% of global transactions.^[16] Developing countries like India are likely to have a far more significant proportion of cross-border transactions within the MNE groups and are subject to transfer pricing regulations. This requirement potentially increases the usefulness of an effective transfer pricing dispute resolution mechanism like APA.

The filing of a large number of APA applications in India by the taxpayers is a testimony of their confidence in the Indian APA programme to resolve the transfer pricing disputes. The experience suggests that applicants have, by and large, provided full cooperation in the APA process leading to the logical conclusion of the process and signing of agreements. The APA Teams could not process some applications due to non-cooperation from the taxpayers.

The government and the CBDT are committed to effective implementation of the APA programme and have adopted a solution-oriented approach for providing certainty to the taxpayers as far as the issues regarding transfer pricing are concerned.

There is a genuine concern about the pendency of a large number of applications for disposal. Processing of the applications takes time. The APA Teams should be able to dispose of applications with speed after they gain experience on all types of cases, and the taxpayers furnish comprehensive and quality economic analysis along with the application. A majority of the applications filed now are for the renewal of APAs. The processing of these applications is likely to be swift, and this will help reduce the processing time.

There were concerns regarding the confidentiality of information disclosed in APA applications or furnished during the processing of applications. However, during the six years of the APA programme and since the inception of transfer pricing laws in India, there have not been any issues in this regard. The tax authorities are required to keep all information received from taxpayers confidential. The taxpayers waive the confidentiality provisions concerning the exchange of specific information with the tax authorities of other countries based on the commitments of India in the bilateral or multilateral agreements. For example, India exchanges information on APAs with its exchange of information partners according to Action 5 of the OECD/G20 BEPS Project^[17] based on the compliance to the minimum standard agreed by India being a member of the Inclusive Framework on BEPS.

Time taken to finalize APA depends on the complexity of the case and the cooperation of the taxpayer. However, attempts need to be made to complete the process in a time-bound manner. These attempts may include simplified requirements for small and medium-sized enterprises, prioritizing specific applications based on defined parameters, and ensuring an appropriate and continued availability of skilled and experienced resources for the programme.

The conclusion of APAs lead to the creation of the right business environment and investment climate in the country. It also improves the country's position in the World Bank ranking of ease of doing business. The programme has made good progress, and hopefully, as the tax administration gains more experience and taxpayers continue to repose confidence in the APA programme, India can provide a non-adversarial tax regime for the MNEs operating in India, leading to further improvement in the investor-friendly climate in the country.

16. OECD Work on Taxation (2018-19), available at <http://www.oecd.org/tax/centre-for-tax-policy-and-administration-brochure.pdf> (accessed 1 Oct. 2019).

17. OECD/G20, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: Final Report 2015* (5 Oct. 2015), Primary Sources IBFD.