Overview and Understanding

Advance Pricing Agreements (APA) & Mutual Agreement Procedures (MAP)

March 2015
Advance Pricing Agreements (APA)
APA provisions – a broad overview (1/2)

• APA provisions introduced with effect from 1 July 2012
• ALP shall be determined on the basis of prescribed methods or any other method
• APA can be entered into for either determining the ALP or specifying the manner in which the ALP is to be determined
• To cover Unilateral as well as Bilateral/Multilateral APAs
• Valid for a maximum of five consecutive years (renewal possible)
• In case an APA covering a particular year is obtained after filing the return of income, a modified return to be filed based on the APA and assessment or reassessment to be completed based on such modified return
• Will cover existing (by March 31) as well as new international transactions (any time during the previous year)
• Flexibility in determining ALP available to taxpayers

**Introduction of the Roll back mechanism by Finance Act 2014 provides that agreement reached under the APA could be applied for a maximum of 4 preceding years**
APA provisions – a broad overview (2/2)

- Specified format for APA application - withdrawal/renewal of APA application possible
- Mandatory pre-filing consultation (anonymous filing also possible)
- APA Directorate includes panel of experts such as Economists, Statisticians, etc.
- Annual compliance report to be filed / annual compliance audit to be conducted
- The schedule of APA filing fees (payable at the time of filing main application) is as follows:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Fees *</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to Rs 1 billion</td>
<td>Rs 1 million</td>
</tr>
<tr>
<td>Up to Rs 2 billion</td>
<td>Rs 1.5 million</td>
</tr>
<tr>
<td>Over Rs 2 billion</td>
<td>Rs 2 million</td>
</tr>
</tbody>
</table>
APA process overview

Phase I - Pre-Filing Application

Pre-filing Application → Pre-filing Consultation → Understanding, determining the scope of agreement

For transactions to be undertaken during FY 2015-16, application to be filed by 31 March 2015

Phase II and III - Final Application and Negotiations

Final APA application

Unilateral APA → Bilateral APA → Multilateral APA

Director General of Income Tax → Competent Authority in India → Competent Authority in other countries

Option of withdrawal of application any time before finalization of APA

Hearings, information requests, site visits etc

Phase IV - Finalization of APA

Mutually agreed draft APA to be prepared → Finalization Exchange of comments on draft APA and finalization of APA → Post APA Requirements Annual Compliance Report & Compliance Audit

Option of Anonymous Pre-filing consultation

For new transactions, application to be filed before entering into the transaction

For new transactions, application to be filed before entering into the transaction
Normal route vis-à-vis APA route

APA when concluded, might have a persuasive impact

TP Audit concluded

Subsequent Financial Years

Advance Pricing Agreement

Roll back option

Validity period: APA entered into during 2015-16

Transfer Pricing Compliance Report and Accountant's Report

Conclusion of Transfer Pricing Assessment / Regular Assessment at Assessing Officer / Transfer Pricing Officer level

Conclusion of first level appeal – Dispute Resolution Panel / Commissioner of Income-tax (Appeals)

Conclusion of second level appeal – Income Tax Appellate Tribunal

*Estimated timelines
Pre filing consultations (PFCs) (1/3)

International Best practice

- Jurisdictions across the world commence APA discussions with a PFC (mandatory or voluntary)

Mandatory Pre-filing

- Serves as a screening mechanism to discuss issues on hand and achieve a resolution for taking the APA negotiations forward
- Provides negotiating parties an opportunity to outline a realistic anticipated time-table for agreeing an APA
- Taxpayer can get a sense of whether it would be fruitful to initiate the formal process of filing an APA application or it would be more prudent to walk away

‘Anonymous’ Pre-filing

- Opportunity for taxpayers to gauge and understand Revenue reaction to the proposed APA behind a screen of anonymity, with no fear of adverse outcome
- Accordingly, taxpayers could evaluate corrective measures to re-energize the proposal to address potential barriers
<table>
<thead>
<tr>
<th>Preparation for Pre-filing</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Taxpayer should assemble pertinent information in a coherent way which facilitates evaluation of information quickly and efficiently</td>
</tr>
<tr>
<td>▪ Pre-filing submission should be drafted in a way that it captures the salient features of the proposal and the core arguments effectively</td>
</tr>
<tr>
<td>▪ Careful sorting would be required to assess what is most relevant for the purpose of pre-filing so as to not swamp the APA authorities with irrelevant documentation at the pre-filing stage and choke the initial proceedings itself</td>
</tr>
<tr>
<td>▪ Care should be exercised while relying on methodologies followed in past TP documentation especially if the taxpayer has faced an adverse outcome in the regular TP audits in the preceding years</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Filling the form</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Key lies in how the taxpayer drafts answers to the information requirements in the Form 3CEC – especially the areas which require subjective analysis or estimation.</td>
</tr>
<tr>
<td>▪ While some particulars require preliminary and basic information, others merit meticulous attention and careful drafting. Ambiguity should be avoided</td>
</tr>
</tbody>
</table>
What happens if the Pre-filing negotiations are unsuccessful?

- In the event of unsuccessful Pre-filing negotiations, the perception that the entire preparatory effort was an exercise in futility may be erroneous, as
  - the preparatory information and documentation readied for the PFC could easily form the basis of compliance at the time of regular TP audit
  - the preparatory effort for the APA would save the taxpayer’s time and effort later at the time of TP compliance and documentation

- Regarding apprehension that disclosure of information during the pre-filing stage may lead to the dissemination of sensitive and confidential information, it should be noted that
  - where an MNE takes the initiative to enter the APA process, it has a fair degree of control over the information that it provides the tax authority
Pre filing consultations (PFCs) …Practical Hints

APA proposal at the Pre-filing stage

- The APA proposal could take the form of a presentation and slide deck
- The prescribed form should be filled up accurately - may require a fine balancing act between precision and brevity

Discussion Process

- Pre-filing meetings should be used to upfront clarify what both sides expect from the APA process.
- Discussions should typically focus on:
  - identifying TP issues and agree on the international transactions;
  - agree on the scope of the APA;
  - confirm the type of APA,
  - choice of the most appropriate or any other method;
  - Benchmarking analysis.
- Tax authorities may also agree to develop the initial APA case plan and to discuss the process for acceptance into the program, including agreeing on a timeframe for lodging a formal APA application.

APA pre-filing meetings do not bind either party to the APA Program
APA – 5 Phase Approach

Phase 1: Pre-Filing Consultation (Form 3CEC)
- Suitability
- Discuss the process, scope of covered RPTs
- Documents and data required for negotiations

Phase 2: APA Evaluation
- Post prefiling, the APA Team confirms/rejects its acceptance of the request for an APA

Phase 3: The APA Application (Form 3CED)
- Detailed application containing information on the entity, AEs, RPTs, industry, TP method, critical assumptions, etc. to be filed

Phase 4: Negotiation and Agreement
- Site visits, discussions, joint meetings, submission review to gain a better understanding
- Position of the APA team is discussed and agreed with the taxpayer
  - Taxpayer and the CBDT signs the APA

Phase 5: Drafting and Compliance
- Annual compliance report and compliance audit for the APA term
Other important provisions

Revision

APAs can be revised by the Board either suo moto or on the request of the taxpayer / Director General of Income-tax – International Taxation (‘DGIT’) / Competent Authority (‘CA’) in case of change in critical assumptions; failure to meet conditions subject to which the agreement has been entered into; change in law; or request from the CA of other country in case of BAPA and MAPA.

Acceptance of APA

The applicant taxpayer needs to communicate acceptance or otherwise to an APA agreed between CAs within 30 days.

Cancellation

An APA may be cancelled in case of failure of the taxpayer to comply with the terms of the agreement; or failure to file the annual compliance report in time; or if the annual compliance report filed contains material errors; or if the applicant does not agree for revision of the APA.

Renewal of the Agreement

Renewal is permissible, however no pre-filing consultation would be required in case of a renewal.
APAs – Key takeaways from practical experience

Factors to be kept in mind

- **Evaluate / select a suitable APA mechanism** (Unilateral/Bilateral/ Multilateral) based on facts and circumstances regarding complexity of transaction, costs involved, past TP audit history
- **Pre-filing consultation** – relevant information to be compiled in a comprehensive manner
- **Adverse outcome in earlier TP audits** should be factored in by the taxpayers while deciding on TP methodologies to be adopted for the APA process
- **Identify challenges** upfront so as to facilitate smooth negotiation with the APA authorities
- **Answers to information requirements** should be carefully drafted and should not be ambiguous
- **Taxpayers should have adequate preparation** for site visits to be conducted by APA authorities – should be well versed with all relevant details to assist the APA authorities in conducting a smooth visit
- **Timelines for information requirements** should be adhered to by the taxpayers
Typical transactions for APAs

- Software Development & ITES services
- Contract R&D (Pharma / software)
- Contract manufacturing
- Payment for intra-group services
- Intercompany Loans, advances and guarantees
- Start up companies with expected losses attributable to local reasons
- Reimbursement of AMP expenses and related transactions
- Intangibles related transactions
  - Technical royalty / technical know-how fee payment
  - Brand name royalty
  - Outright sale / purchase of intangibles
APA Negotiations – Experience so far

Overtime CBDT has concluded various Unilateral Agreements and a Bilateral APA with Japan within a short time span as compared to international timelines in finalising such APAs which is a major step in providing certainty to the tax payer...

- 378 applications filed in two years - 146 in the 1st year (117 Unilateral and 29 Bilateral) and 232 in the 2nd year (206 Unilateral and 32 Bilateral)
- Large MNCs are part of initial set of companies to participate in the program
- ‘Anonymous Pre-filing’ – no downside
- Approach of the APA team thus far has been rational and pragmatic
- Discussions in the conferences comparable with international standards
- Unilateral APAs expected to be concluded in a time frame of 9-15 months subject to timely submission of relevant details by taxpayers
- International TP experts attending have welcomed the approach and pragmatism of the Indian APA team

Recent discussions between CAs of India and US resulted in strong anticipation for US to recognize India’s APA programme and begin acceptance of bilateral APA applications
### Benefits of opting for an APA

- **Opportunity to explain “price-setting”, business strategies, business rationale. Emphasis on understanding the business.**

- **Leverage global methodologies inter-alia followed in APAs in other jurisdictions**

- **Opportunity to explain/provide justification for global policy (e.g. rationale for revenue split)**

- **Potential use of 6th method or other approach permitted under APA.**

- **Ability to agree cost base / mark-up in advance**

- **Specific to company facts and circumstances**

- **Not constrained by industry-wide approach**
Key issues and considerations

- Absence of firewalls - Confidentiality of information (especially forecasts, estimates)
- Absence of timelines for completion for APA proceedings
- Skill levels of APA teams
- Bilateral APAs – relationship with treaty partner, DTAAs where Article 9(2) or equivalent does not exist
- Consultation process – for unilateral APA as well as for Bilateral APAs

APA route – Advantages outweigh the concerns
The Finance Ministry has reiterated the "spectacular response" that the Indian APA program has received.

Government sources have highlighted that hardly any anonymous applications have been filed, which they say is a pointer that taxpayers have reposed faith in the program.

The APA applications are believed to be covering a wide range of important TP issues.

There seems to be keen interest in the APA program from diverse sectors. MNC giants from pharmaceuticals, consumer electronics, media, cement, telecom, etc. are learnt to have filed applications.

Some Indian companies too, have filed for APA. These factors, Revenue officials say, is indicative of the fact that the APA program is being received well by taxpayers.

In order to smoother process - APA Guidance with FAQs - issued by CBDT
Mutual Agreement Procedure (MAP)
MAP - Overview

• Mutual Agreement Procedure (MAP) is
  – an alternate mechanism
  – for the resolution of international tax and transfer pricing disputes
  – which are not in accordance with tax treaty

• Resolution of disputes through
  – the intervention of the Competent Authorities (‘CAs’) of each state
  – Aim to arrive at a mutually acceptable solution (resolution not a compulsion for the CAs)

• Relief through MAP possible irrespective of remedies available under domestic tax laws

• Potential of a negotiated settlement – agree to disagree
Discussion framework - MAP

- Article 25 of the OECD Model Tax Convention 2010 and relevant tax treaties
- Manual on Effective Mutual Agreement Procedures (MEMAP) issued by OECD
- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Chapter IV - Section C)

21
Article 25 – OECD Model Tax Convention

• A person considers that actions of one or both contracting states leads to or shall lead to taxation not in accordance with the treaty

• Such person shall make an application to the Competent Authority of his country of residence to resolve the matter

• Application to be made within 3 years of being aggrieved - PARA 1

• The Competent Authority of such country to endeavor to resolve the matter, else shall involve the other Competent Authority

• An agreement reached would be applicable irrespective of the time limits in domestic law - PARA 2

• The resolution may be reached by mutual discussion of the Competent Authorities, for elimination of double taxation - PARA 3

• The Competent Authorities may communicate with each other in person or through representatives for reaching a conclusion - PARA 4
Who/What is a Competent Authority

• Article 3: Competent Authority - Persons with the competence of the highest tax authorities

• A typical designation of a Competent Authority -
  – Minister of Finance; or
  – Secretary of the Treasury.

• Rule 44H – ‘Competent Authority of India means an officer authorised by the Central Government for the purposes of discharging the functions as such’
Mechanism of MAP

Tax Dispute

Appellant approaches the CA in the country of residence (Home country)

Dispute Capable of Unilateral resolution?

YES

Should be resolved by CA of country of residence

NO

MAP

Should be resolved by Consultation
Steps in MAP process

1. Filing Application with CA of Home Country
2. CA has discretion to admit application
3. Making representation to CA of home country
4. CA of home country & host country to consult
5. Making representation to CA of host country
6. MAP resolution issued by CA of home & host country
7. Implementation of Solution
MAP and Indian Rules

RULE 44G

- Applicable to resident assessee
- Aggrieved by action of the tax authority outside India
- Such action is not in accordance with the agreement or tax laws
- May make an application to CA in India to invoke MAP

Example: Indian software companies affected by taxation in US and sought the help of Indian CA to resolve the issue

RULE 44H

- Indian CA receives a reference from CA outside India
- Indian CA shall call for and examine the relevant records
- Indian CA shall endeavour to arrive at a resolution
- Resolution arrived at shall be communicated to DGIT or CCIT wherever necessary
- Assessee can give his acceptance to the resolution and withdraw the appeal under traditional avenues
Article 9 – Issues to be considered

• Whether corresponding / correlative adjustments are mandatory?
  – The right to carry the corresponding adjustment in the other country primarily arises from Article 9(2) of the OECD Model
  – If the countries have inserted the provisions of Article 9(2) in the double tax treaty, then those countries can make a corresponding adjustment subject to acceptance of the principle and quantum

• Is Article 9(2) independent of Article 9(1) or does Article 9(1) define the scope of Article 9(2)?
  – Adjustment to a deemed international transaction as per Indian Transfer Pricing regulations – whether Article 9(2) will apply?

• Whether MAP procedure applicable if the relevant DTAA does not include Article 9(2)?
Categories of disputes covered under MAP

Specific provisions
- Specific cases, where taxation is not accordance with the DTAA

General interpretation issues
- Issues relating to interpretations of certain terms and provisions

Issues not covered under DTAA
- Economic double taxation, including transfer pricing adjustments
Some practical examples of invoking MAP

- Double Taxation Avoidance Agreements (DTAA) are available for capturing and curtailing juridical double taxation
  - A person is considered resident in both countries and income of such person is taxed in both countries (as in the case of a PE),
  - Existence of a PE?
  - Attribution of income, expense, deductions, etc to the PE
  - Tax is withheld in excess of the rates applicable in the DTAA
- DTAAAs generally do not cover instances of economic double taxation
  - Same income is taxed in two different countries in different taxpayers’ hands (as in the case of a transfer pricing adjustment)
- MAP also provides relief in cases where automatic relief, such as tax credits, tax exemption, etc. are not available
- Transfer Pricing situations under Article 9 (Associated Enterprises) or Article 11 (Interest) or under Article 12 (Royalties & Fees for Technical Services)
Strengths and Weaknesses of MAP

• **Strengths:**
  – Tax demands raised are stayed on furnishing a bank guarantee
  – Can be pursued parallel with the domestic appellate proceedings
  – Taxpayer could choose whether to follow the MAP decision or not
  – More than one assessment year could be clubbed in a MAP application
  – MAP decision would provide finality to the issue as it would override the decision of the CIT(A)/ Tribunal, at the option of the taxpayer
  – Incase of bilateral resolution involving CAs of two countries has an advantage of avoiding economic double taxation

• **Weaknesses:**
  – Complete relief unlikely, as settlement through negotiation process between the CA
  – Time consuming process
  – A personal hearing before CA is not mandatory
  – If errors or omissions are found in the MAP application, the CA may reject the application
What happens when mutual agreement is reached?

• Decision of a Competent Authority is generally case specific and not a precedent for
  – the taxpayer for subsequent years; or
  – other taxpayers on same issues.

• Decision of the MAP process is communicated to the taxpayer by a letter

• The decision of the MAP process is then implemented vide Rule 44G & 44H

• The Assessing Officer gives effect of the decision of the MAP, after receiving instructions from the CCIT / DGIT (within 90 days of receiving instructions)

• If taxpayer is aggrieved by decision of the Competent Authority, he may reject the decision and go ahead with the remedies under the domestic law
Relief from tax collection, interest and penalty

• Under MAP, collection of tax should ideally be suspended till the end of MAP process

• Indo-US DTAA - MoU:
  – Collection of demand shall be suspended till a MAP is disposed
  – In India, an irrevocable Bank Guarantee to be provided
  – In USA, an irrevocable Letter of Credit to be provided
  – Demand will include demand from appeal, re-assessment, revision, withholding tax
  – If Bank Guarantee or Letter of Credit lapses, it has to be substituted

• Indo-UK DTAA - MoU and CBDT Instruction No. 3/2004:
  – Time limit under section 220(3) to be extended till MAP is disposed
  – AO and Addl. CIT are advised to keep a close watch on the limitation of bank guarantee

• Rule 44H – The amount of tax, interest or penalty already determined shall be adjusted after incorporating the decision under MAP
Arbitration

• Current MAP structure - CAs not required to resolve MAP cases, only endeavor to agree

• Where CAs are unable to reach a viable solution, MAP as a whole fails

• Newly added paragraph 5 to Article 25 of the OECD Model Convention provided for an arbitration mechanism to supplement MAP
  – Where a person has presented a case to the CA under Article 25(1) and the CAs are unable to reach an agreement under Article 25(2) within 2 years from the presentation of the case to the other CA
  – Any unresolved issues shall be submitted to arbitration if the person so requests
  – Recourse not automatic
Timelines for MAP

- MAP application filed within 3 years of being aggrieved
- Intimation to CCIT for stay of demand on furnishing of bank guarantee within 2 months
- Acceptance of MAP application and notification to taxpayer within 1 month
- Analysis & Evaluation by the CA and issuance of position paper within 4 to 6 months
- Negotiation between CAs within 6 months
- Mutual agreement between CAs and drafting of MoU within 6 months
- Exchange of closing letters within ASAP
- Approval of mutual agreement by the taxpayer within 1 month
- Implementation of mutual agreement within 3 months
- The MAP process may take around 30 to 36 months

Legends:
- CA: Competent Authority
- CCIT: Chief Commissioner of Income-tax
- MoU: Memorandum of Understanding
Over 70 MAP cases signed. Mostly MAP with US, Japan and UK

MAP cases mainly categorised into ITES, IT/Software and R&D Services

Proposed to make MAP a truly effective mechanism for resolving TP and International tax disputes - endeavor to resolve MAP cases within 12 months

No instructions on the action to be taken by the AO where case is being simultaneously processed under MAP and appeal

Presently India and USA authorities are working to resolve a gap on transfer pricing margins determined in relation to IT-ITES services in each country

India currently considers a minimum margin of 18% towards related party transactions with USA, whereas in contrast, USA authorities consider 12-13 percent adequate as a margin that maybe offered for taxation

After much analysis India had adopted a rate of 18% as per the last MAP discussion – however considering the margin of 12 -13% is internationally accepted, India will need to look towards resolving this gap through various means such as bilateral APAs

Recently India and US CAs agreed upon a broad framework for resolving disputes under MAP in relation to the IT-ITES Sector – this to help expedite resolution of 80 – 100 MAP cases for multiple years in the IT-ITES sector
APA v/s MAP
<table>
<thead>
<tr>
<th>Issue</th>
<th>APA</th>
<th>MAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time</td>
<td>Comparatively less time consuming – takes anywhere between 9 -15 months</td>
<td>Time consuming - takes anywhere between 20 to 30 months for resolution</td>
</tr>
<tr>
<td>Documentation</td>
<td>Requisite information to be provided to APA authorities through a mandatory pre-filing process to arrive at a ‘set price’ followed by detailed documentation during main filing stage</td>
<td>Competent Authorities of both countries would generally require detailed analyses</td>
</tr>
<tr>
<td>Participation by taxpayer</td>
<td>Filings take place in presence of taxpayer and APA authorities after authorities have perused business facts and information (viz. functions, pricing, etc). Option to undertake anonymous filing. Tax payer holds option to enter into bilateral / multi lateral APAs</td>
<td>Competent Authorities generally involve the taxpayer in information gathering, explanation of facts. However, taxpayer and representatives are not party to bilateral negotiations</td>
</tr>
<tr>
<td>Payment of demand</td>
<td>Not Applicable</td>
<td>Demand put in abeyance fully if Bank Guarantee provided</td>
</tr>
</tbody>
</table>
| Advantages                    | • Opportunity to explain price setting and agree on cost base / mark –up in advance  
                                 | • Permits use of 6th Method or other approach permitted under APA  
                                 | • Valid for 5 years without requirement of annual TP audits         | • It is a ‘Win-Win’ situation  
                                 | • Demand is stayed in full  
                                 | • Negotiated settlement  
                                 | • Taxpayer may not accept |

APA v/s MAP
Q&A

Questions

&

Answers
Disclaimer:

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

Presenter’s details:

Hasnain Shroff
Partner – Global Transfer Pricing Services
Tel: +91 22 3090 2719
Email: hshroff@kpmg.com