

STRATEGIC DELIBERATION OF APA FEASIBILITY: SPECIFIC BUSINESS SCENARIOS

Introduction

In today's dynamic global trade environment, determining the pricing of cross-border transactions between related parties is both essential and complex for



NITYA SRINIVASAN



CA. E. RAJESH

multinational enterprises ('MNEs'). Transfer pricing regulations often result in disputes between taxpayers and tax authorities, leading to prolonged litigation and uncertainty.

Organisation for Economic Co-operation and Development (OECD) as part of administrative approaches to avoid and resolve transfer pricing disputes included Advance Pricing Arrangement (Agreement) as a dispute resolution mechanism.

APAs were introduced in India by Central Board of Direct Taxes ('CBDT') through Finance Act 2012 by inserting Section 92CC and Section 92CD in the Income Tax Act, 1961 ('the IT Act') and Rule 10F to 10T and Rule 44GA in Income-tax Rules, 1962 w.e.f July 1, 2012. APA is a formal agreement between a taxpayer and a tax authority that pre-establishes the transfer pricing methodology for related-party transactions, typically involving MNEs, for a defined period – 5 year forward looking and 4 year roll back.

APAs have gained significant global recognition as an effective tool for addressing transfer pricing disputes and ensuring tax certainty.

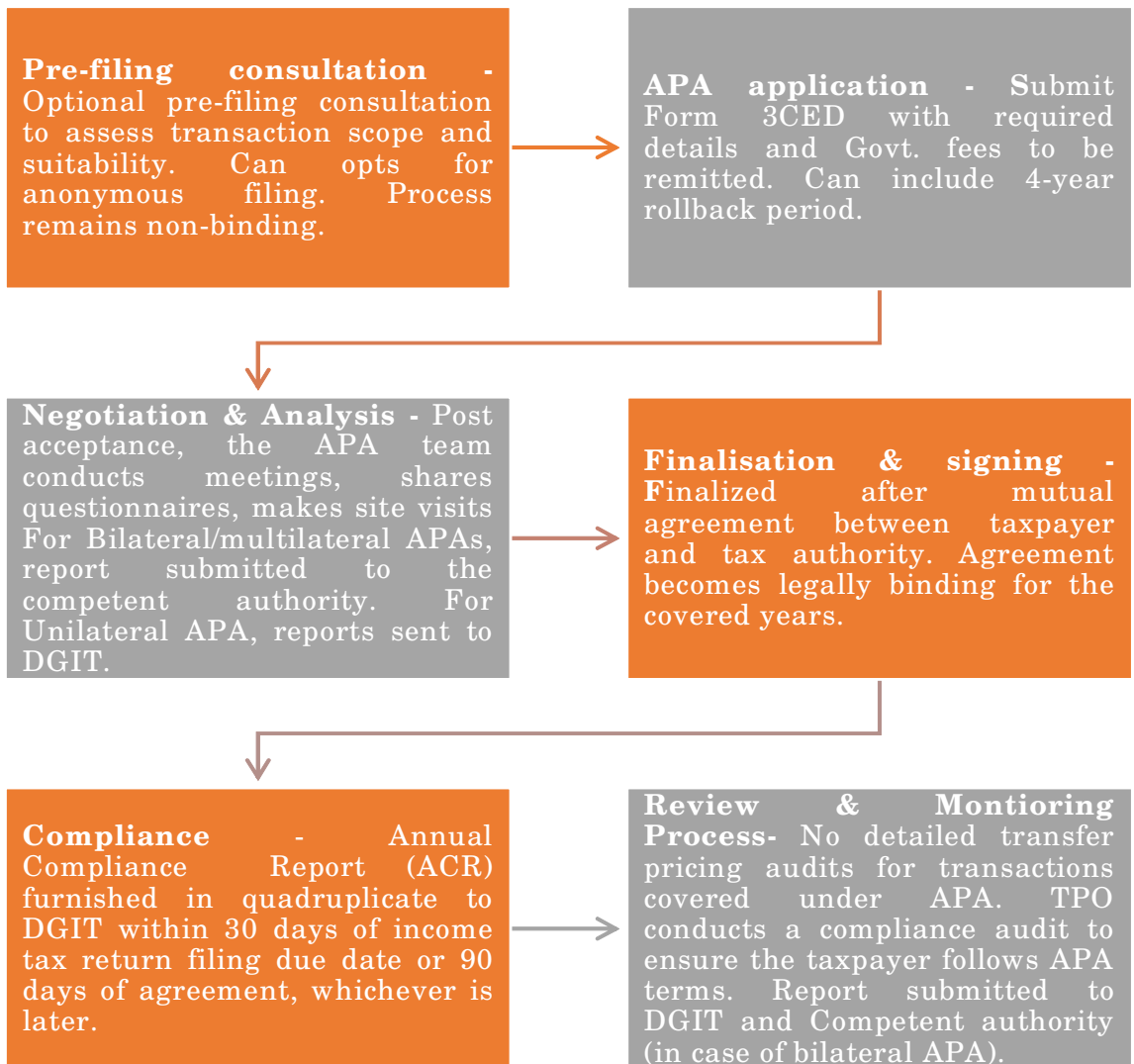
There are several dispute resolution mechanisms available for taxpayers w.r.t. transfer pricing and it is important for the taxpayers to evaluate the features of each of the dispute resolution in light of the facts and circumstances of the transfer pricing litigation / potential litigation of the taxpayer in order to opt for the most effective as well as efficient dispute resolution route for the taxpayer. Among the dispute resolution mechanisms, Taxpayers have opted for the APA more as a defacto approach. Hence, taxpayers at large have flooded the APA program, especially where APA may not be the most efficient for the taxpayer 's business circumstances. This article dwells on various strategic aspects and nuances of APA program which taxpayers will have to critically weigh-in before considering APA as the most appropriate dispute resolution mechanism.

A. Rationale for Introducing APAs:

- **Minimizing Litigation** - Transfer pricing disputes, often centered on the arm's-length principle, are a contentious aspect of international taxation, leading to audits / assessments, and resulting in financial strain for businesses / taxpayers. APAs offer a proactive solution by establishing an upfront agreement on TP methodologies between businesses and tax authorities, fostering mutual clarity and reducing the likelihood of future conflicts. While a unilateral APA offers a dispute resolution for the taxpayer alone, bilateral / multilateral APA provides wholistic and complete dispute resolution for both / all the Group entities for the relevant transaction.
- **Aligning with Global Practices** - The introduction of APAs in India aligns with global tax practices, ensuring consistency and harmonization with international standards.

- **Efficient Tax Administration** - From a tax administration perspective, APAs streamline the compliance process by reducing the need for the usual TP audits under the normal litigation route. This enables tax authorities to devote resources more effectively to focus on other high-risk TP cases.

B. APA process in India:



A. Key Considerations before filing of APA application

Considering the costs & efforts involved, it is imperative that a detailed analysis is undertaken before APA application is filed. The following are some of the key considerations that taxpayers will have to bear in mind w.r.t. various transaction groups:

i) Limited Risk entities:

Transactions entered by limited risk entities including provision of IT / ITeS / EDS services are one of the largest number of service related transactions for which applications have been filed by taxpayers as well as concluded. Some of the key aspects that taxpayers w.r.t. limited risk activities should have in my mind are—

- **Free of Cost Assets (FoC):** During the course of operations, the parent / Group entities might provide certain tools or assets to the taxpayers free of cost. The position taken by the APA authorities is that the total costs should include these free of costs assets, on this cost base mark-up will have to be computed. In certain instances, the costs of these assets are ascertained and included in the cost base, while in most of the cases the APA authorities compute FoC as a percentage of the cost base, translated to a mark-up % and the targeted mark-up is accordingly increased.

Taxpayers have to examine in detail the assets used in its operations, which are provided by the associated enterprises. Thereafter, an analysis will have to be undertaken by the taxpayer to evaluate whether these assets are essential for performance of the services. In an uncontrolled transaction, third party service recipients would provide certain assets to service providers for the purpose of rendering the services. Taxpayers may use a parallel line of argument to defend these FoC, if one opts for the litigation route.

APA authorities usually attribute 2-5% of the cost base as FoC. Where taxpayers can identify actual FoC and if these FoC is uncommon / one-of instances or there is a decreasing trend in provision of these FoC, taxpayers will have to negotiate with the APA authorities w.r.t. non-inclusion of an ad-hoc FoC into the targeted mark-up. FoC is a crucial decision point on the way forward in filing an APA else taxpayer might want to consider if the issue of FoC can be efficiently defended through the normal litigation route itself.

Further the indirect tax implications in connection with FoC, at times, is not considered by taxpayers while undertaking APA cost benefit analysis.

- GST implications: Indirect tax implications have a connection with transfer pricing, more so with regard to APA. Changes in the transfer price of international transactions pursuant to conclusion of the APA is

the base for evaluating indirect tax related impact. Hence even more important for taxpayers to accurately forecast the outcome of an APA in order to be able to ascertain the total costs and take a more informed decision. For example, taxpayer pursuant to APA conclusion is deemed to have accepted FoC and considers the same as part of mark-up, the indirect tax authorities would compute the GST on the FoC. Further interest may also be levied. Where the APA is concluded in 3-4 years after the application, indirect tax outflow would be approximately 28% of the FOC viz., GST of 18% and interest of 6-8%). Indirect tax authorities might also revisit earlier years – from the commencement of GST regime, which can compound the tax outflow. In instances of delay in the conclusion of APA, the indirect taxes might be sunk costs. Since these indirect taxes are actual incremental cash flows and have to be remitted to tax authorities in a short term, taxpayers' existing working capital will be displaced, causing undue burden on the finances of the taxpayers.

Similarly, where pricing for new transactions are finalised pursuant to the APA conclusions, their indirect tax implications will have to be evaluated.

Where the international transactions are predominantly purchases from AEs, changes in the expected margins might result in changes in import prices and consequently customs related implications would have to be factored.

-
- **Safe Harbour Rules:** Eligible assessee entering into eligible international transaction can evaluate alternate efficient dispute resolutions such as Safe Harbour, before APA is considered. The outcome of Safe harbour rules is relatively similar to that of APA w.r.t. the agreed mark-up for eligible transactions such as Software development, ITeS and BPO. The key aspect while undertaking a Cost-benefit analysis is to ensure that all the costs are factored. Usually, taxpayers consider only monetary costs or costs only until the APA sign-off. However there are compliance costs involved post APA conclusion on ACR and ACR audit. All this needs to be considered before deciding the APA option. With the analysis of these finer aspects, it may result in cost efficiency for the taxpayer by opting under Safe Harbour if thresholds are met.

Taxpayers undertaking non-routine or complex activities usually opt for APA as a dispute resolution mechanism. In this context, reference to Circular 6/ 2013 can be used as a yardstick for determining whether or not the activities / functions of the taxpayer are non-routine. If the functions / activities are within the framework of Circular 6/ 2013 and within the threshold limits, Safe harbour should be evaluated / considered.

- **Renewal:** During renewal of APA, there is an expectation by the APA authorities to increase the targeted outcome (mark-ups) compared to the previous APA agreement. This is because the APA authorities are of the

view that the taxpayer would have moved up the value chain - that usually arises on account of learning curve from performing the activities over a period of time. This is an important aspect in cases where taxpayers assume that mark-up / terms agreed in the APA can be 'rolled-forward' over the couple of APA cycles.

ii) Royalty:

Payment of royalty has been a long and largely litigated issue in the transfer pricing landscape. Litigation in connection with royalty includes determination of most appropriate method to benchmark the transaction – CUP (Comparable uncontrolled price) vs TNMM (Transactional net margin method), benefit test, restriction of royalty to certain ad-hoc threshold limits by the Transfer pricing officer / Revenue. Taxpayers that are subject to litigation on payment of royalty consider filing APA application. Based on the facts of the taxpayers, APA authorities tend to agree on royalty and generally require adequate profits are earned by the taxpayers. In case of losses, taxpayer should have strong economic rationale to defend payment of royalty, since generally APA authorities impose a covenant that royalty can be paid only if EBIT is positive

In the event of recognising royalty only on the conclusion of APA, taxpayers will also have to take into account the impact of Section 92(3) – elucidated in the ensuing sections.

APA authorities are more open to adoption of non-traditional approaches and hence alternate royalty models such as flexible royalty - variable royalty can be discussed in an APA. However, taxpayer should be judicious in approaching APA authorities on these alternative approaches and consider filing APA for these alternatives only where there is a strong economic rationale. Even where a variable royalty is accepted in an APA, the entire residual profits are not considered as royalty and only a part of such residual profits can be attributed to the parent as incremental royalty. Taxpayer should not consider using non-traditional approach such as variable royalty for repatriating all of the residual profits earned by the taxpayers to the parent / group entities.

Where taxpayers consider introducing payment of royalty on the finalization of APA, taxpayers can consider creating an appropriate provision of royalty for the initial years, so that the taxpayer can claim the deduction w.r.t. royalty for the income offered to tax for the initial years.

iii) Soga Shosha:

Soga Shosha is a general trading / distributing entity, distributing the goods of the parent / group in a jurisdiction. These entities purchase goods from the parent / group based on confirmed orders from third party customers, hence takes flash-title to the goods. Indian tax authorities require that these Soga Shosha entities are compensated on

the entire cost, including the value of goods. While the taxpayers contend that there is no risk assumed in connection with the goods & the taxpayer only takes a flash-title, and therefore compensation on value adding expenses would be appropriate.

Several taxpayers have resorted to a bilateral APA in order to obtain certainty for the group as a whole. Therefore, taxpayers operating on such models can consider filing an APA, where the taxpayer has been subject to protracted litigation on this matter.

iv) General:

Apart from the above issue specific aspects, taxpayers will have to be bear in mind the following while filing an APA application:

- **Existing compliances:** There are several transfer pricing compliances that would have to be undertaken even if the APA has been concluded viz., filing of Form no. 3CEB, TP documentation (with the economic analysis based on the terms agreed as per APA). Hence, taxpayers will have to ensure that these compliance requirements are met in a timely and also factor these costs while evaluating filing an APA application.
- **Secondary Adjustment:** Post the conclusion of the APA, taxpayers are required to give effect to the terms of the APA, such as increased mark-up or reduced payments. One of the key terms / critical assumptions in

the APAs include realization of invoice within the stipulated time-period (usually about 90 days). Secondary adjustment would be initiated for delayed realization. Since realization is usually part of critical assumptions, TPOs scrutinise the same during compliance audit.

- Application of 92(3): Before filing an APA application certain taxpayers earn higher mark-ups as compared to generally accepted / concluded terms in similar APAs. In such cases if the taxpayers file APA application, the APA authorities will not conclude the mark-up that is lower than the existing mark-up earned by the taxpayers. Therefore taxpayer should not consider using APA as an avenue to reduce mark-up and simultaneously obtain tax certainty / buy-in from the APA authorities. This is parallel to Section 92(3) of the Income-tax Act, 1961.

In certain cases, taxpayers file for an APA for introduction of new expense transaction such as royalty or intra-group services, and do not recognise any provision in connection with these new expenses. Instead, taxpayers contemplate on recognising the expenses on finality of the APA. In this situation, even though certainty would have been obtained for these expenses, the taxpayers will not be able to recognise the expenses for initial covered years that have passed by since giving effect to royalty/ IGS transaction would result in reduction in the income of the taxpayer – which is not allowed as per Section 92(3) and as per APA.

Therefore, in order to ensure that the full benefit of the APA is reaped, taxpayers can consider creating a reasonable quantum of provision for these expenses for the initial years, and based on the conclusion of the APA the differential can be reversed, and additional tax can be paid.

- **Parallel TP assessment:** Filing of APA application does not keep the transfer pricing assessment proceedings – 92CA in abeyance. There are instances where for the covered years transfer pricing assessment proceedings have been initiated and tax demands have been issued. Hence, where taxpayers have been continuously selected for transfer pricing scrutiny or there is a reasonable probability / ground for selection of scrutiny u/ s/ 92CA, taxpayers should ensure that the costs with regard to these assessments is estimated and factored in the cost-benefit analysis.
- **Post APA compliances:** After the sign-off/ conclusion of APA, there are compliances, which the taxpayer will have to undertake filing of modified returns, filing of annual compliance report (ACR) and APA compliance audit.

ACR has to be filed with the Income tax authorities for each of the covered years and include information such as covered transaction & TP methodology, any changes in the functional analysis (functions performed, assets deployed and risks assumed), critical assumptions as

per the APA agreement and detailed documentation / information substantiating that terms and critical assumptions have been complied with.

Apart from filing of the ACR, the TPO will conduct compliance audit to verify whether the terms and conditions as well as the critical assumptions as per the APA agreement has been complied with by the taxpayer.

Costs of all these activities will have to be factored while evaluating the feasibility of APA.

- **APA Term:** The APA program covers 5 forward looking years and 4 roll back years, totalling to 9 years. In certain cases, taxpayers opt for a shorter term such as 3 years. Usually, taxpayers justify this approach stating presence of uncertainty beyond the 3-year period. In such cases, taxpayers can consider delaying the filing of APA application and file the same where there is reasonable certainty on the international transactions (5 years or beyond).

To put into perspective, taxpayers considering a 3-year period would incur double the costs vis-à-vis a 5-year period. That is there would be three cycles of APA applications filed in 3-year period, while for a 5-year period there would be only two cycles of APA applications being filed.

D. Costs of APA

The below table summarises some of the heads of costs incurred w.r.t. APA:

S No	Costs
1	Government Fees
2	Consultant Fees
3	TP compliance for the covered years (TP documentation) and TP assessment proceedings till conclusion
4	Post APA compliance – Filing of modified returns, ACR and compliance audit.
5	GST – FoC, etc (Interest and GST - Sunk cost)
6	Interest u/ s 234
7	Secondary adjustments

A. Conclusion

APA generally is considered as a panacea of dispute resolution due to its flexibility. APA is indeed ‘the’ dispute resolution where taxpayers can seek to agree with the revenue for application of non-conventional / non-traditional approaches w.r.t. transfer pricing. However, taxpayers should undertake a detailed & wholistic evaluation of various dispute resolution mechanisms and ensure a robust cost-benefit analysis is undertaken to understand if APA is the most appropriate dispute resolution mechanism for facts of the taxpayer.

In Summary, it is best for taxpayers to file APA applications where complex transactions are involved and seek certainty with the revenue, which might not otherwise be agreed by the Transfer pricing officer / Assessing officer, or the taxpayer has been subject to protracted litigation. Through this the Indian APA as a dispute resolution mechanism would become more efficient and provide taxpayers with much needed tax certainty.

(The authors are part of VSTN Consultancy Private Limited, Transfer Pricing boutique firm and can be reached at snithya@vstnconsultancy.com and rajesh@vstnconsultancy.com)