

# *Certainty in the uncertain world of Transfer Pricing*

Whitepaper on APA in India  
2011



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# Foreward



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Since the introduction of transfer pricing regulations in various parts of the world, transfer pricing has emerged as one of the largest sources of tax controversy for Multi-National Enterprises. One needs to understand and appreciate that the exercise of transfer pricing has direct and significant bearing on the tax revenue of a country. Therefore, transfer pricing is the focal point for revenue authorities around the world, which has led to documentation requirements, in-depth examinations and the resultant litigation.

Advance Pricing Agreements (APAs) have served as an effective tool to proactively address transfer pricing issues across the globe. Many countries have used APAs in order to provide certainty to both taxpayers and the government, thereby reducing transfer pricing audits and litigation.

Though APAs at present are not available in India, the Indian Government has proposed to introduce APAs under the Direct Taxes Code effective from 1st April, 2012. As the rules are yet to be formulated, the proposed APA mechanism in India is not very clear and the Indian Revenue can look at the best practices followed by other jurisdictions having well established APA programmes. This whitepaper discusses the concept of APA and best practices in various countries which India could consider while designing its APA programme and drafting relevant rules.

I appreciate the hard work of the PwC India team in developing this whitepaper, as it creates an awareness of the subject in India and also may assist the Indian Revenue while framing the APA rules based on global best practices. PwC also recently assisted the Australian Tax Office to review its APA Program and this whitepaper further demonstrates the active participation of PwC in developing and improving global tax practices.

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# Introduction

Transfer pricing, in plain language, is the art of pricing cross-border transactions entered into between two or more companies of the same multinational group (related parties/associated enterprises). How can something that sounds so simple and routine become so important? The answer lies in the fact that more than 60 percent of the global cross-border transactions are undertaken between related parties; add to this the fact that the tax regimes in different countries differ significantly from one another and almost all countries have different tax rates (albeit, these gaps are now getting narrower than in the past) and we have a perfect recipe to create conflicts between all parties involved (taxpayers and tax authorities).

This is further accentuated by the increasingly complex nature of intercompany transactions that, at one extreme, could be just a simple arrangement of providing certain services under a captive service model, and to another extreme involving a complex arrangement to jointly develop and exploit certain intellectual property.

When one looks at the development cycle of the field of transfer pricing in countries where it is now at a developed stage, it is interesting to note that each tax authority chose to undergo a very similar process of trial and error, over and over again, instead of seeking to adopt the learning of other nations. This is easier said than done.

India introduced detailed transfer pricing regulations in 2001 and since then India has been no exception to the above development cycle as experienced by other countries; we have been experiencing our own set of issues through the trial and error method of implementing these regulations, both from the tax authority as well as the taxpayer perspective.

In recent times, the Indian Transfer Pricing scenario is making headlines; with the sixth transfer pricing audit cycle completed, the adjustment on account of transfer pricing issues (all six cycles put together) grossed up to INR 50,000 crores (approximately US\$ 11 billion). The transfer pricing adjustment in the sixth audit cycle alone amounted to INR 20,000 crore (approximately US\$ 4.5 billion). The recent conclusion of the first cycle of the Dispute Resolution Panel (DRP) process, and matters now with the Income-tax Appellate Tribunal (ITAT), certainly makes transfer pricing one of the most contentious tax issues in India. In today's date, the number of cases involving transfer pricing disputes at the ITAT level is unprecedented – to put things in perspective, India contributes to more than 70 percent of transfer pricing disputes (in number) worldwide.

While the Indian tax system has always enjoyed a reputation of being a difficult one, the foray of transfer pricing disputes has further elevated our status on this count.

The above discussion raises two obvious questions:

- First, can anything be done to address this situation or do we have to wait for the jurisprudence to develop through the natural course of our judiciary system over a period of time?
- Second, what is being done to address the situation?

In addressing the first question, one needs to consider the parameters required to assess transfer pricing disputes. The most

important point to be understood by all concerned is that the subject of transfer pricing, while it stems from the tax laws, is not a law in itself. It is closer to the art of business economics. Transfer pricing closely follows business decisions and intentions underlying an intercompany transaction. Therefore, it is important to understand the business rationale and relevant facts and circumstances while analysing the transfer prices adopted for a particular intercompany transaction.

It is also equally important to realise that transfer pricing issues cannot follow a formula based approach (with certain exceptions), and application of fundamental transfer pricing principles involves a high degree of subjectivity. However, if these principles are applied appropriately, one would expect to see a high level of convergence in the results obtained by different parties, even when there are some differences in the approaches adopted.

Each business is different, the people involved (management) are different and the business rationale is different from transaction to transaction – these are just some of the reasons why no two cases can be looked at in the same manner while considering transfer pricing disputes. The decision to price a particular intercompany transaction depends on several factual criteria and circumstances that are peculiar to that case. Given the highly fact intensive nature of these decisions, each transfer pricing dispute must be analysed separately considering the facts and circumstances that are relevant only to that case.

Following the above discussion, it is clear that a court decision in connection with a particular transfer pricing dispute cannot be applied to another case also involving a transfer pricing dispute. It would not be an exaggeration to say that such comparisons may not be meaningful even in cases involving transfer of identical goods, as one has to closely analyse the terms and conditions involved and the peculiar circumstances of each such transaction.

This limits the extent to which one can rely on judicial precedents to develop the subject of transfer pricing. That said, there are and will be certain areas related to transfer pricing disputes that are purely questions of law; in such cases, the judicial precedents will surely play a significant role. However, such issues are limited – e.g., how should one apply the +/- 5% rule, can multiple year data be used for comparability analysis, etc.

Clearly we cannot afford to continue living with the current state of affairs where:

- Any significant intercompany transaction is faced with a high risk of protracted litigation
- Every transfer pricing dispute takes more than five years to be resolved with several cases where companies are waiting for more than seven years to finalise their tax liability from these transactions.

Businesses cannot continue to operate with such gross levels of uncertainty; as a matter of fact, the transfer pricing disputes and level of uncertainty in India has already forced many Multinational Enterprises (MNEs) to reconsider their decision to invest in India. Currently, a taxpayer has to wait for more than five years from the completion of any cross-border transaction with a related party, for a verdict of the Indian Revenue on the aspect of transfer pricing implications. This uncertainty and lack of clarity in matters relating to transfer pricing has pushed back several large investment proposals of foreign MNEs in India, thus having a negative impact on the Indian economy and also the Indian tax administration.

The Authority for Advance Rulings has been in existence in India for a long time with an objective to provide certainty about the tax impact of a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant. However, there is no such mechanism available for providing certainty on transfer pricing matters.

This brings us to the next question – what is being done to address the situation?

Transfer pricing is, by no means, a simple issue to tackle, and the current state of affairs only adds to the complications as the government as well as the taxpayers are now faced with the challenge of defending what has been done in the past, and considering significant changes in approaches that may be fundamentally different (possibly even opposite in some cases) to the approaches adopted in the past.

Through the below actions, the government has certainly demonstrated its awareness of the situation and its willingness to address it:

- Through Finance Act of 2009 - introduction of safe harbour provisions and institution of DRP as an alternative mechanism to address disputes in this area
- Through the proposal to introduce Advance Pricing Agreement (APA) as part of the Direct Tax Code (DTC) which is posed to be effective from 2012

The above initiatives are clearly reflective of the government's recognition of the facts that transfer pricing matters are highly fact intensive and subjective in nature, and therefore, there is a need to provide alternative mechanisms to handle these disputes in a harmonious manner.

On one hand, introduction of safe harbour provisions is aimed at reducing the volume of transfer pricing disputes by providing a formula based approach for certain class of transactions. On the other hand, the DRP and the APA programs are aimed at providing alternative venues to resolve these disputes.

The purpose of this whitepaper is to provide a well rounded understanding of APAs and create an awareness of the subject in India. The whitepaper would also assist the Indian Revenue while framing Indian APA rules based on global best practices. Virtually all the major

developed and developing countries have well defined APA mechanisms as part of their transfer pricing regime. For example, China began using APAs on a trial basis in the late 1990s and in 1998 it concluded its first unilateral APA. Keeping this in view, an emerging country like India, which is the desired destination of virtually all MNEs, cannot just lag behind. In this respect, the initiatives of the Indian Government for introduction of APA in India are highly appreciated, though there needs to be more awareness amongst the Taxpayers and the Revenue for the success of the APA programme. With that objective, the paper is structured in the following sections:

- APA – The Concept
  - What is an APA?
  - APA Types
  - The Scope
  - When to Consider an APA?
  - Benefits and Points to Consider
- APA Programme – The Structure
- Functioning – Process Flow
- Best Practices
- Points to Ponder
- Worldwide Perspective – Country Chapters



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# APA – The Concept

## What is an APA?

An APA is an arrangement between the taxpayer and the tax authority covering future transactions, with a view to solve potential taxation disputes in a cooperative manner. The taxpayer and tax authority mutually agree on the transfer pricing method to be applied and its application for a certain future period of time. An APA is thus a pre-transaction analysis, rather than a post mortem (though favourable outcome of APA negotiations can also be used for retrospective application or settlement of past disputes).

APAs can be used for any class of intercompany transactions, e.g., dealings in goods/services, financing arrangements, transfer and use of tangible/intangible assets, etc. However, as can be seen in country specific chapters below, different countries apply different criteria to accept cases for APAs.

OECD Transfer Pricing Guidelines for MNEs and Tax Administrations (OECD Guidelines) define an APA as:

*“An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time”*

The Internal Revenue Service (IRS) defines an APA as:

*“An APA is an agreement between a taxpayer and the Service in which the parties set forth, in advance of controlled transactions, the best transfer pricing method (TPM) within the meaning of § 482 of the Code and the regulations. The agreement specifies the controlled transactions or transfers (covered transactions), TPM, APA term, operational and compliance provisions, appropriate adjustments, critical assumptions regarding future events, required APA records, and annual reporting responsibilities.”*

The IRS further describes the APA Programme as:

*“The Advance Pricing Agreement (APA) Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method.”*

It is helpful to note one of the IRS' stated principles of its APA Programme:

*“The APA Program provides a voluntary process whereby the Internal Revenue Service (Service) and taxpayers may resolve transfer pricing issues under § 482 of the Internal Revenue Code (Code), the Income Tax Regulations (the regulations) thereunder, and relevant income tax treaties to which the United States is a party in a principled and cooperative manner on a prospective basis. The APA process increases the efficiency of tax administration by encouraging taxpayers to come forward and present to the Service all the facts relevant to a proper transfer pricing analysis and to work towards a mutual agreement in a*

spirit of openness and cooperation. The prospective nature of APAs lessens the burden of compliance by giving taxpayers greater certainty regarding their transfer pricing methods, and promotes the principled resolution of these issues by allowing for their discussion and resolution in advance before the consequences of such resolution are fully known to taxpayers and the Service.”

Furthermore, the proposed DTC provides the following with respect to India’s APA programme:

*118(1) The Board, with the approval of the Central Government, may enter into an advance pricing agreement with any person, specifying the manner in which arm’s length price is to be determined in relation to an international transaction, to be entered into by that person.*

*118(2) The manner of determination of arm’s length price referred to in sub-section (1) may be any method including one of the prescribed methods, as referred to in sub-section (1) of Section 117, with such adjustments or variations, as may be necessary or expedient so to do.*

*118(3) The arm’s length price of any international transaction, in respect of which the advance pricing agreement has been entered into, notwithstanding anything in this Chapter, shall be determined in accordance with the advance pricing agreement so entered.*

*118(4) The agreement referred to in sub-section (1) shall be valid for such financial years as specified in the agreement which in no case shall exceed five consecutive financial years.*

*118(5) The advance pricing agreement entered into shall be binding—*

*(a) only on the person in whose case the agreement has been entered into;*

*(b) only in respect of the transaction in relation to which the agreement has been entered into; and*

*(c) on the Commissioner, and the income tax authorities subordinate to him, only in respect of the said person and the said transaction.*

*118(6) The agreement referred to in sub-section (1) shall not be binding, if there is any amendment to the Code having bearing on the agreement so entered.*

*118(7) The Board may, by order, declare an agreement to be void ab initio, if it finds that the agreement has been obtained by the person by fraud or misrepresentation of facts.*

*118(8) Upon declaring the agreement void ab initio, the provisions of this Code shall, after excluding the period beginning with the date of such agreement and ending with the date of order under sub-section (7), apply to the person as if such agreement had never been entered into.*

*118(9) For the purposes of this section, the Board may, by notification, frame a Scheme for advance pricing agreement in respect of an international transaction.*

The APA provisions in the proposed DTC are broadly in line with the global practices. However, the Central Board of Direct Taxes (CBDT) still has to frame a detailed scheme for APAs in respect of an international transaction which shall be communicated to the taxpayers in due course.

From the above, an APA has the following salient features:

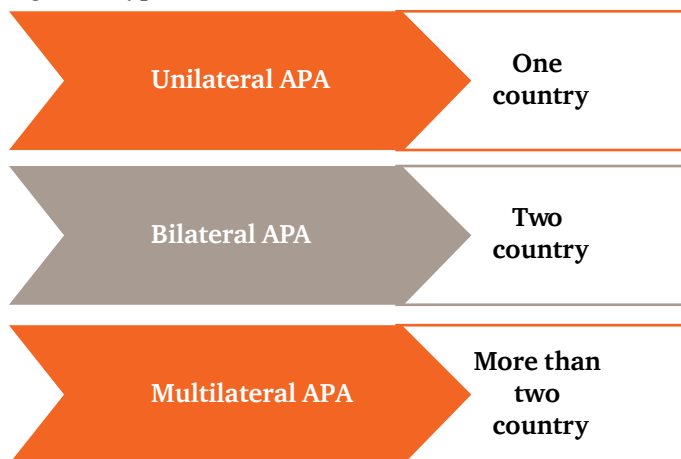
- Agreement between a taxpayer and one or more tax authorities
- Covers future intercompany transactions
- Covers a fixed period of time
- Follows domestic and internationally accepted transfer pricing principles
- Most importantly, is negotiated in a cooperative setting between the taxpayer and the tax authorities



## APA Types

There are three types of APAs.

Figure 1: Types of APAs



### Description

Unilateral APA is an agreement between a taxpayer and the tax administration of the country where it is subject to taxation. A bilateral or multilateral APA is entered into between the taxpayer, the tax administration of the country where it is subject to taxation and one or more foreign tax administrations.

### Unilateral vs. Bilateral/Multilateral APAs

Implementing a unilateral APA is considered to be simpler than a bilateral/multilateral APA. However, as unilateral APAs are not recognised by a foreign tax authority, the risk of double taxation still exists if the foreign tax authorities do not agree with the method of computing the arm's length price or the result thereof. Therefore, in the interest of 'sound tax administration' and the elimination of any double taxation potential, taxpayers as well as the tax administrations prefer bilateral/multilateral APAs over unilateral APAs. However, bilateral/multilateral APAs tend to take a longer time to conclude as more than one tax administration is engaged in the process. In such cases, the tax administrations may choose to provide a unilateral APA to the taxpayer.

While there can be situations where a unilateral APA might be preferable over a bilateral/multilateral APA, such situations are limited. More often than not, it would be in the interest of the tax authorities as well as the tax payers to enter into bilateral/multilateral APAs for the reasons discussed above.

### The Scope

#### Covered Transactions

APAs can be applied for a variety of transactions, e.g. dealings in goods/services, financing arrangements, transfer and use of tangible/intangible assets, etc. However, keeping in view the time and resources required for concluding an APA, it is generally preferred to enter into an APA in respect of complex/high value transactions. Certain jurisdictions also exclude routine transactions from the scope of the APA.

Though APAs can be applied for a variety of transactions, the application of an APA to the transactions is generally left to the discretion of the taxpayer. The taxpayer can decide the intercompany transactions to be covered under an APA. Usually there is no requirement that all related entities or all intercompany transactions must be covered. However, it is important to fully

disclose all the intercompany transactions proposed to be entered into by the taxpayer to the relevant tax authorities. In certain cases, if the tax authorities are of the view, that it would be important to include certain other intercompany transactions (originally proposed by the taxpayer to be excluded) for various reasons, the tax authorities may discuss with the taxpayer and mutually agree to include such transactions. The proposed DTC also provides for entering into an APA with the Indian Revenue for specific transactions. It provides that the APA entered into shall be binding only on the person in whose case the agreement has been entered into and only in respect of the transaction in relation to which the agreement has been entered into.

### The Term

The scope of the APA also describes the time period for which the APA shall remain in force. Generally an APA is entered into for a duration of three to five years and may be renewed/re-negotiated upon completion of the originally agreed term. Under the DTC, the APAs are proposed to cover terms up to a period of five years.

While there is no magically right number of years to be covered under an APA, given the amount of effort involved that goes into executing an APA, and the main objective of providing certainty to the taxpayer, it would not be meaningful for an APA to cover less than three years. Furthermore, considering the amount of time that it takes before an APA is concluded, especially in the initial years of an APA Programme of a country when the machinery is still in the start up phase, it would be advisable for the APA to cover at least three future years after the execution of the APA. This will ensure appropriate benefits to both the taxpayer (in terms of certainty and reduced compliance burden) and the tax authorities (in terms of reduced efforts in transfer pricing audit) over that period.

## Roll-Back

An APA is, by definition, a future looking agreement, i.e., it is to be applied for controlled transactions over a future period of time. However, the negotiated position under an executed APA can be applied to prior years which are not covered by the terms of an APA. This is also known as 'roll-back' of an APA. Roll-back is an effective way of resolving open transfer pricing issues using the information and TPM already agreed with the tax administration. The 'roll-back' mechanism is regularly used as a technique by many countries (e.g., USA, U.K., Australia etc.; please refer the respective country chapters for details) to resolve prior year issues in a more co-operative environment than that of a transfer pricing Audit/examination.

The taxpayer may request the tax administration to consider a roll-back in connection with a particular APA. Even in the absence of a roll-back request, the tax administration may propose to apply the same or a similar TPM as that agreed under the APA to prior years.

Feasibility of a roll-back in particular case is based on the consistency of the facts, law, critical assumptions and availability of records over the period of time. Roll-back of an APA is particularly dependent upon the similarity of the facts as given in the APA to the facts existing in the prior years in relation to which roll-back is proposed. If the facts are not materially different, adjustments may be made to reflect differences in facts, economic conditions and applicable regulations while applying the roll-back of APA to the prior years that are open.

## Renewal

Towards the end of the original APA term, the taxpayer may approach the relevant tax authorities for renewal of the APA. An APA renewal can be a very simple and quick process if:

- There are no significant changes in the covered transactions
- There are no changes in the relevant transfer pricing regulations

In such situations, depending on the case, the tax administration may not even require a full blown application to be filed and may be willing to use the original application as the basis.

APA renewal provides an excellent leverage off the time and efforts expended during negotiating the original APA, which makes it a 'win-win' situation for both the taxpayers and the tax administration, as the benefits of the original APA can be reaped over an extended period of time.

### Critical Assumptions

A critical assumption refers to facts, the continued existence of which is material to support the applicability of the TPM agreed under the APA. The critical assumptions may relate to the taxpayer's operations, a third party, an industry, or business and economic conditions and could include – a particular mode of conducting business operations, particular corporate or business structure, range of growth in volume/profitability of a business or industry, specific macroeconomic indicators (say Gross Domestic Product Growth rate), the relative value of foreign currencies, etc.

The following are the examples of

common critical assumptions which may form part of an APA depending on the facts and circumstances of the case:

Type of Critical Assumptions	Nature of Constituents
Operational	Activities, risks, functions, business methods, assets, business structure, intangible asset ownership
Legal	Law changes, major regulatory changes, maintenance of a distributor agreement
Tax	Estimated tax liability, permanent establishment, foreign tax credit limitation
Financial	Gross/operating margins
Accounting	Use of accounting standards and policies, consistency of accounting principles, unqualified audit opinions
Economic	Market condition, technology, market share, interest rates

For the application of a concluded APA TPM, it is important that the business activities, functions performed, risks assumed, assets employed, financial accounting methods, and categories and estimates of the taxpayer remain materially the same as presented and used during the APA negotiation process. A change in any of the critical assumptions may result in corresponding change in the APA or may lead to re-negotiation, or even termination of an APA.

As critical assumptions are important for the continued application of an APA, generally the critical assumptions are set in a broad manner so as to ensure that every small change in the facts/law should not lead to a time consuming APA re-negotiation, or even worse, failure of the APA.

### Reporting

Taxpayers are required to submit reports demonstrating compliance with the terms of the APA on an annual basis, generally known as an 'APA Annual Report', within a specified time frame. The documentation needed for the years covered by the APA is discussed and agreed while concluding an APA. These reports usually substitute the formal documentation required under the transfer pricing legislation.

The purpose of an APA Annual Report is to provide the necessary information to the relevant tax administration to demonstrate that the critical assumptions laid out in the APA have not been violated, and that the TPM, as agreed under the APA, has been followed.

For the covered transactions, over the APA term, the tax administration may require the taxpayer to establish:

- Compliance with the APA's terms and conditions
- Validity and accuracy of the annual report's material representations
- Correctness of the supporting data and computations used to apply the TPM
- Satisfaction of the critical assumptions
- Correct application of the agreed TPM

Non-compliance with the APA reporting requirements could lead to cancellation of the APA. However, these requirements generally are less complex and less onerous than the documentation requirement under the relevant transfer pricing regulations. Once an APA is

executed, there would usually be a considerable reduction in the time and cost required in maintaining documentation stipulated under the transfer pricing legislation.

For the transactions not covered under the APA, the general transfer pricing provisions for documentation requirements would continue to apply.

### When to Consider an APA?

APA is one of the several important tools that can be made available to the taxpayers to choose from for addressing their transfer pricing matters. A taxpayer should carefully evaluate a particular situation at hand in considering whether an APA is an appropriate approach to resolve/address that situation. The following considerations should be evaluated while deciding whether to go for an APA:

#### What is the Objective - Certainty vs. Flexibility?

The biggest benefit one can possibly achieve through an APA is certainty. In today's world, where the global economy provides for one common market place, and considering that the tax rates in major jurisdictions across the world are becoming increasingly similar, it is utmost importance for a taxpayer to achieve certainty on various counts to be able to stay ahead of the competition. In such a scenario, when income tax rates average around one third of the total profits, there is significant value in securing certainty for transfer pricing matters.

While an APA provides a high degree of certainty over the APA term, subject to continued satisfaction of the critical assumptions, there is a trade off one has to accept vis-a-vis flexibility. Usually APAs are entered into with an intention, on both sides, to ensure successful completion of the APA term as agreed. Given this common intention of the parties involved, a relatively small amount of changes

during the APA term is usually acceptable. In fact, statistics suggest that even in cases involving significant changes such as merger, acquisition or demerger, if the original conditions can be reasonably satisfied, the taxpayers and the tax administration have been able to find a way to make the APA work.

However, once a taxpayer enters into an APA, it does take away the ability to make fundamental changes to the TPM. While, generally speaking, it is not advisable to frequently change the TPM applied for a particular intercompany transaction, if the taxpayer expects significant changes in its business, which could be due to several factors, it may be desirous of having the ability to change its TPM. In such a situation, it might be advisable to not enter into an APA.

Though it is true that there is reduced flexibility under an APA for change of TPM during the APA term, an APA does provide a different type of flexibility – in terms of selection of the TPM. Particularly, in the case of bilateral/multilateral APAs, the relevant tax administrations exhibit flexibility in adopting a certain mutually agreeable approach even if it is removed from their respective domestic transfer pricing provisions. Such flexibility cannot be expected under the regular route as each of the tax administration is bound to follow their domestic transfer pricing legislation.

#### Time and Cost

The APA process is a time consuming process and can take a significantly greater amount of time and resources as compared to a tax audit through the regular channel. Unilateral APAs can take 12 to 18 months to conclude and bilateral APAs can take more than 24 months. Multilateral APAs can take even longer, given the level of complexity just by virtue of having more than two tax administrations involved.

That said, one needs to consider the above time frames bearing in mind that an APA is

a one-time process that can cover up to five years plus some of the past years if roll-back is permitted. While on one hand, it can take a long time to conclude an APA, considering the timelines involved in pursuing usual channels of dispute resolution (litigation) in India, it might be a better option.

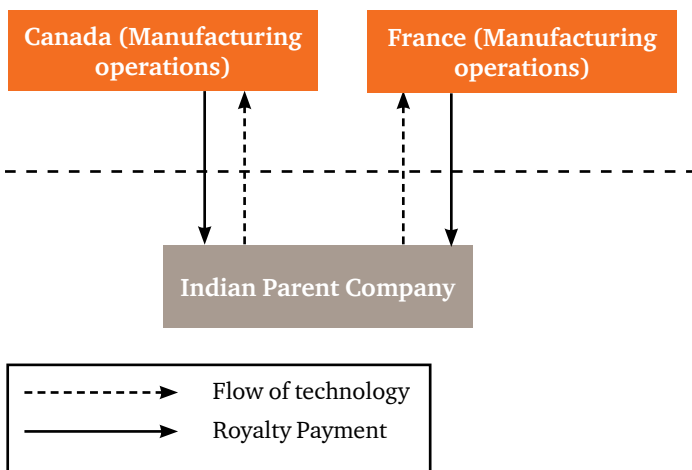
**Information Control**

This is yet another important factor to consider while deciding whether to pursue an APA. While negotiating an APA, since it is a forward looking process, there is a requirement to share a great degree of information involving not only the past positions, but also the future plans and forecasts of the taxpayer. On the other hand, if the taxpayer opts to go with the regular tax audit cycle, the information requirements are limited to the issues involved for the year under audit.

**Examples**

Below are a few examples when it would be advisable to consider an APA:

Figure 2: Example 1



**Government Support (Bilateral APA)**

Facts of this case:

- India headquartered multinational group with subsidiaries in Canada and France
- Indian parent company has developed and owns the technology involved in the manufacturing process
- Canadian and French subsidiaries are licensed manufacturers engaged in manufacturing of widgets using the technology licensed from the Indian parent company
- Canadian and French subsidiaries pay a royalty at the rate of five percent of sales to the Indian parent company for use of the manufacturing technology
- Canadian subsidiary was audited by the Canadian Revenue Agency (CRA) for FY 2009-10 – while no additional tax was assessed, there was a threat of challenging the royalty payment going forward

In this case, if the taxpayer chooses to follow the normal route, it will have to take on the might of the CRA single handed.

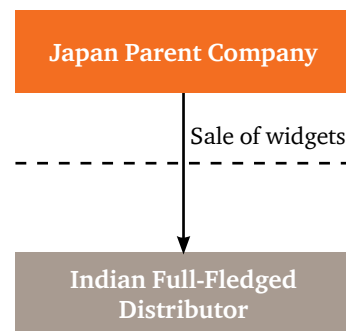
One helpful argument in this case would be the fact that the multinational group is following a consistent royalty policy worldwide. However, that fact in itself would not prove the arm's length nature of the royalty transaction.

In this case, as a proactive measure, the taxpayer may consider a bilateral APA with the CRA and the Indian tax administration. Under an APA scenario, the taxpayer will have the benefit of having the Indian tax administration on its side while analysing and negotiating the arm's length price for the royalty transaction. This could be a huge benefit, especially if the Canadian subsidiary is expecting lower profitability in future years, or even a loss situation.

The CRA on one hand may push to lower the royalty rate; while on the other hand, the Indian tax authority will support the taxpayer in maintaining the level of the royalty rate, or depending on the facts of the case, may even push to increase the royalty rate.

**Operating Losses**

Figure 3: Example 2



Facts of this case:

- Japan headquartered multinational group with a subsidiary in India
- Japanese parent company is engaged in manufacturing widgets and owns the technology involved in the manufacturing process
- Indian subsidiary is a full-fledged distributor performing all the routine functions of a distributor such as:
  - Buying the widgets from the Japanese parent company and selling in the domestic market
  - Marketing and distribution functions
  - Logistics and inventory management functions
  - Billing and credit management functions
- Indian subsidiary also assumes all the normal risks associated with its profile as a full-fledged distributor such as: market risk, inventory risk, credit risk, etc.
- Indian subsidiary has experienced ups and downs in its profitability over the past couple of years. While it expects to earn an appropriate level of profit over a period of time, the volatility is embedded in the nature of the market in which it operates.

Under the normal route, where the Indian tax authority is tuned to examine the Indian subsidiary on a year on year basis, one can clearly anticipate the issues and potential adjustments in each year of loss. A situation like this can be well addressed through an APA using a ‘term test’. What it means is that the taxpayer can agree with the tax administration to evaluate its profitability over a period of time, i.e., the APA term, instead of looking at it on a year on year basis.

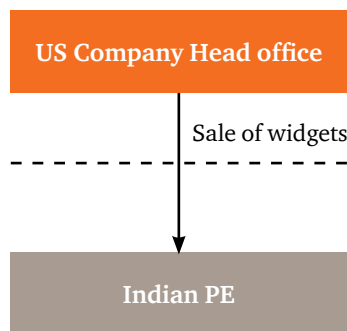
This would save the taxpayer a significant amount of time and effort by eliminating the need to go through the annual transfer pricing audit cycles and the potentially protracted litigation for each of the loss

years. At the same time, it will also provide much needed certainty to the taxpayer for its transfer pricing matters.

From the tax administration perspective, it is also a winning proposition, as it will free up a significant amount of time and resources that it would have to otherwise expend in performing the year on year transfer pricing audit and to support the potential litigation for each of the loss years.

### Attribution of profit to Permanent Establishment (PE)

Figure 4: Example 3



Facts of this case:

- US headquartered (HO) multinational company with a Branch office (BO) in India
- HO is engaged in manufacturing widgets and owns the technology involved in the manufacturing process
- Technology is the key value driver for the business
- Indian BO is a low risk market support service provider performing routine functions of a service provider such as:
  - Conducting market research in the Indian market
  - Identifying potential customers for HO products
  - Sharing product catalogue and price list with potential customers
  - Acting as a communication channel between HO and potential customers

- Indian BO assumes normal risks associated with its profile as a low risk service provider
- Indian BO is not involved in price negotiation or conclusion of sale contract
- Indian BO has experienced low but stable cost plus margin over past couple of years

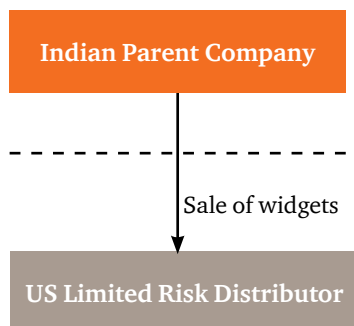
Under the normal route, the Indian Tax Officer may challenge the characterisation and the profitability of the Indian BO. The Tax Officer may allege that the Indian BO performs important functions in respect of sale of products and conclusion of contracts, and may try to attribute additional profits to the Indian BO. The tax payer can proactively engage the respective Competent Authorities through a bilateral APA request to agree upfront the methodology for attribution of profit to the Indian PE.

This would save the taxpayer a significant amount of time and effort. Furthermore, the taxpayer can have the assurance of maximum exposure on account of the BO in India. It is also important to mention that where the BO has transactions with HO, the case may also be referred for transfer pricing audit; entering into an APA can resolve dual issues of transfer pricing audit as well as attribution methodology.

In this regard, it is also pertinent to mention that OECD also recognises that the concept of APAs may also be useful in resolving issues raised under Article 7 of the OECD Model Tax Convention relating to allocation problems, PEs, and branch operations. Recognising that APAs can be an effective tool for resolving the litigation in respect of attribution of income to a PE, several jurisdictions (e.g., USA, U.K. etc.) have included it in the scope of APAs.

## The Overachiever

Figure 5: Example 4



### Facts of the case:

- India headquartered multinational group with a subsidiary in the US
- Indian parent company is engaged in manufacturing widgets and owns the technology involved in the manufacturing process
- US subsidiary is a limited risk distributor performing routine distribution functions such as:
  - Buying the widgets from the Indian parent company and selling in the domestic market
  - Marketing and distribution functions
  - Logistics and billing functions
- US subsidiary assumes limited risks associated with these transactions consistent with its characterisation as a limited risk distributor
- All significant risks related to these transactions are assumed by the Indian parent company including the market risk, credit risk, inventory risk, foreign exchange fluctuation risk, etc.
- US subsidiary has been earning an operating margin (operating profit over sales) of 10 percent over the past few years, which is not consistent with its characterisation of being a low risk distributor

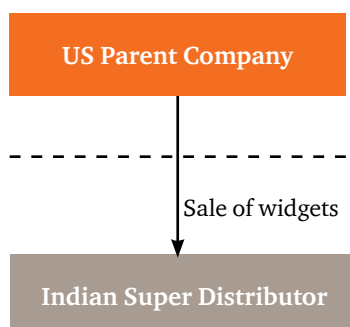
While correcting this situation, the taxpayer may face strong resistance from

the IRS as it would involve lowering the profitability of the US subsidiary. Also, there would be high risk of transfer pricing audit and potential adjustment by the IRS under the normal route. Given the inherent nature of tax/transfer pricing audit proceedings, it would be challenging to meaningfully resolve the dispute at that forum.

In a situation like this, one may consider pursuing an APA which would provide for a cordial setting and cooperative process to address the situation. The taxpayer can proactively work with the tax administration and agree upfront on the best way to correct the profitability of the US subsidiary consistent with its functional characterisation.

## Marketing Intangibles

Figure 6: Example 5



### Facts of the case:

- US headquartered multinational group with a subsidiary in India
- US parent company is engaged in manufacturing widgets and owns the technology involved in the manufacturing process
- Indian subsidiary is a super distributor performing functions such as:
  - Buying the widgets from the US parent company and selling in the domestic market
  - Marketing and distribution functions
  - Logistics and billing functions
- Indian subsidiary has a long-term

exclusive license to distribute the products in the Indian market

- Indian subsidiary incurs significant advertisement and marketing expenses and takes key decisions with respect to marketing strategy
- Indian subsidiary assumes the risks associated with these transactions consistent with its characterisation as a super distributor

In this situation, the Indian taxpayer may face strong resistance from the Indian Revenue authorities, who tend to seek reimbursement of non-routine advertisement and marketing expenses from the legal owner of the brand. Accordingly, there would be high risk of transfer pricing audit and potential adjustment by the Indian tax authorities under the normal route. Given the inherent nature of transfer pricing audit proceedings, it would be challenging to meaningfully resolve the dispute at that forum.

In a situation like this, one may consider pursuing an APA which would provide for a cordial setting and cooperative process. The taxpayer can proactively work with the tax administration and upfront agree on the best way to ascertain the appropriate TPM.

## Other Apt Situations

There can be various other situations involving loss making years for the group companies owing to a variety of reasons such as – implementing market penetration strategy, significant fluctuation in the market cycle, extraordinary events resulting in loss at operating level, etc. Such situations are much easier to handle in an APA setting where both the sides are expected to be cooperative.

Also, cases involving business restructuring such as change of characterisation from a distributor to a commissionaire or from a licensed manufacturer to a contract manufacturer

carry a high probability of potential audit adjustments and protracted litigation. These are very well suited for an APA. One may consider unilateral or bilateral APA depending on the facts and circumstance of the case.

## Benefits and Points to Consider

Benefits	Points to Consider
Low annual reporting cost and certainty with respect to outcome of covered transactions during the APA term	Initial APA submission preparation cost may be high relative to annual documentation costs
Reduces the need for documentation and costs associated with audit and appeals over APA term	Can take multiple years to finalise
Ability to discuss transfer pricing considerations in a pre-filing meeting, which some countries permit on an anonymous basis	Changes in the business during the APA term may reduce its applicability or necessitate modification/potential revocation
Flexibility in developing practical approaches for complex transfer pricing problems	Exposes all aspects of the business because of voluntary nature of the process
Cooperative process with experienced transfer pricing professionals considering the case	May affect established working relationships with local tax authorities
APA team leader is a neutral party providing a fresh look	APA Office may be locked into a position that is inconsistent with that of the taxpayer
Pursuing an APA before an anticipated audit may prevent the audit	Certain tax authorities do not permit taxpayers to request an APA after initiating an audit

# APA Programme – The Structure

For the APA Programme to function successfully and achieve optimal results, it is important for it to be structured in a certain manner. The rest of this section discusses an ideal structure that would be most desirable and instrumental to the success of an APA process.

## Central APA team

A central team must be constituted to take on the responsibility of negotiating and executing APAs on a pan-country basis. This has several benefits of which the major ones are listed below:

### Actual and Perceived Independence

It is important for the APA Programme to maintain an independent status in terms of its thinking vis-a-vis the field audit team. This would help in ensuring voluntary disclosure by and openness on the part of the taxpayers during the APA process. It would also help the APA Programme to be perceived as being an independent body which is not pre-disposed in its approach and unduly influenced by the field audit team. This can only be achieved by having a nationally centralised APA team.

### Consistency

The transfer pricing scenario in India today is characterised by glaring inconsistencies in approaches adopted both by the taxpayers as well as the tax authorities. In the APA context, an inherent challenge while establishing an

APA is the parallel need to rigorously apply the most appropriate TPM and provide for flexibility to address the changing business environment. Agreeing on a TPM that is both rigorous and flexible at the same time is challenging for both the tax administration and the taxpayer.

Consistency can be viewed in two forms – (1) consistent treatment of similar issues across all APAs; and (2) applying similar approaches to different taxpayers in different industries.

While the first form of consistency described above is desired, the second one is not so desirable. This is for the reason that transfer pricing is a highly fact intensive exercise, and one would expect the facts and circumstances to be different when one travels from one industry to another industry.

A central APA team can help achieve consistency of the first form, i.e., in treating similar issues in a consistent manner across the APAs. Of course, one has to be mindful of the peculiar facts and circumstances which might necessitate divergence from the common approach.

## Constitution

Taxpayers and tax administrations are both at risk while entering into an APA. Looking into the future is like gazing into a crystal ball – businesses are growing competitive by the day and today we operate in an extremely dynamic global economy that is capable of changing by the hour. It is this uncertainty that poses the great risks and challenges of establishing an APA.

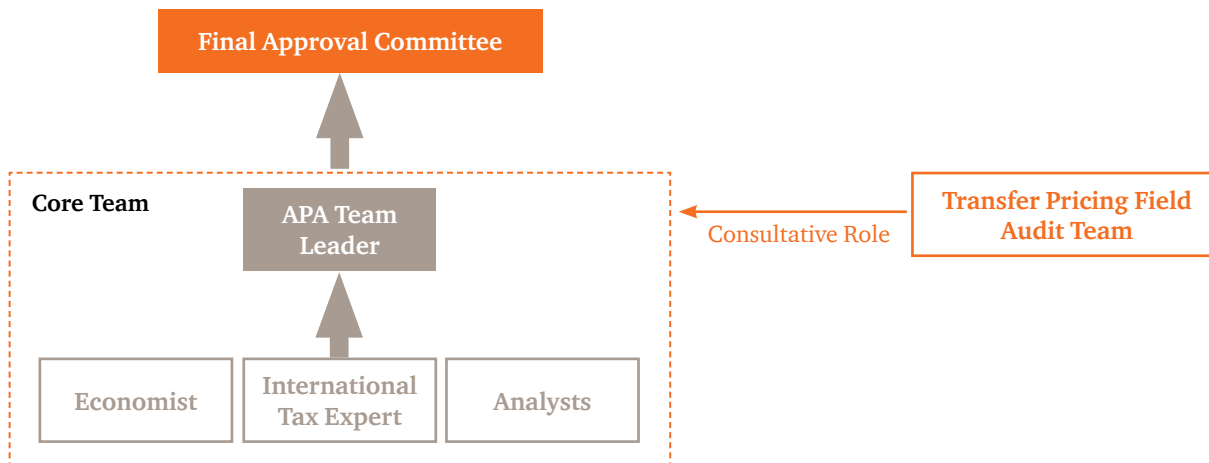
Let's take an example – an APA is executed fixing the royalty as a fixed annual payout. In this case, assuming that the licensor is an Indian company, if the market tanks and the business suffers, the Indian Revenue stands to gain. By the same token, if the market booms and the company achieves significantly higher sales than projected, the Indian Revenue arguably loses. The most effective way to



ensure that such variations are within an allowable margin of error, is to involve experts in relevant fields who can reasonably understand, analyse and validate the projections and other data being used as the basis of establishing the TPM for the APA.

With the above backdrop, it would be ideal to have the following APA team structure within the APA Programme. Upon receipt of an APA application and upon its acceptance, the APA Programme should assign an APA team that would work with the taxpayer on that case.

Figure 7: APA Programme



The APA team leader would have the overall responsibility to:

- Liaison with the taxpayer
- Oversee the functioning of the team
- Solicit technical inputs from various technical teams within the tax administration on different matters, as and when necessary
- Ensure execution of the APA in a timely fashion

The economist would be responsible for closely analysing the propositions put forth by the taxpayer and preparing a detailed position paper after consultation with the necessary experts as well as the taxpayer during the course of the APA negotiation. The international tax expert will be

responsible for providing necessary inputs on the case as and when required, to ensure a well rounded approach to the analysis and addressing the issues on the table.

The analysts would support the APA team leader, economist and the international tax expert in performing their functions effectively by performing necessary research and analysis.

In addition to the APA core team, as shown in the picture above, the field audit team should also be involved in the APA process.

This is important on two counts - (1) to leverage the knowledge gathered by the field audit team through the prior year audits; and (2) over the period of time, to bridge the gap between the field audit team's views and that eventually agreed under the APA.

The role of the 'Final Approval Committee' is very crucial. By whatever name it may be called, the objective of this committee is to:

- Perform the final review of the position proposed by the APA team
- Try to achieve consistency in treating similar issues under similar situations across different APAs
- Ensure consistent application of the

fundamental principles as adopted by the tax administration

In addition to the above key constituents, there is one more very important party which must be involved, especially in the bilateral/multilateral APA process – the Competent Authority. The role of the Competent Authority in the APA process is explained in detail in the next section that discusses the APA process flow.

### Filing Fee

Filing fee, also referred to as the APA user

fee, is the amount charged by the tax administration upon acceptance of an APA application. There is a mixed approach on this point by various tax administrations across the world with established APA Programmes. Some countries charge a filing fee whereas some do not. Among the countries that do charge a filing fee, there are various mechanisms such as – a one-time fixed fee which varies with the size of transactions involved; or where the fees are estimated upon a preliminary review of the application depending on the time and efforts required.

Just like anything else, there are pros and cons of having or not having a filing fee charged by the tax administration. For example, the filing fee could make the APA

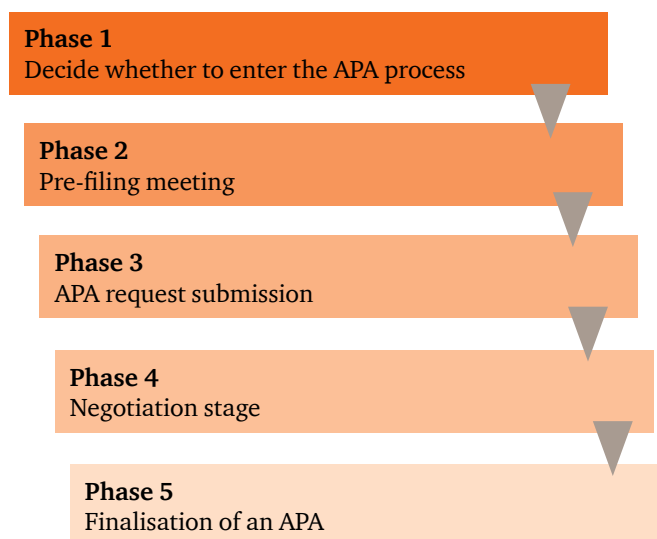
process cost prohibitive on one hand, but on the other hand, it would restrict the APA Programme to issues involving significant amounts. Another point to consider is that the filing fee would enable the tax administration to provide resources necessary for effective functioning of the APA Programme. On the flip side, in the absence of the filing fee, the tax administration might not be able to perform site visits, which is an important element in developing the understanding of the case.

The tax administration should be mindful of the above points while deciding whether to institute an APA user fee or not.

# Functioning – Process Flow

The APA process is detailed in nature and, as it spans over a period of time, it involves several logical steps. The chart below provides a diagrammatic representation of the various steps involved in the APA process. Each of these steps might not be required in all cases and so the process has to be tailored case to case. For example, a bilateral APA involving complex transactions is likely to involve each of these steps, whereas, renewal of a simple APA where the facts and circumstances have not significantly changed might skip several of these steps.

Figure 8: APA Process Flow



## Pre-filing Meeting

A taxpayer interested in an APA may wish to explore and clarify in advance various aspects of a potential APA and informally discuss issues, e.g., the proposed transactions to be covered, the proposed methodology, likely documentation requirements, etc. Pre-filing meeting(s) between the taxpayer and the APA Programme provides an excellent venue for this purpose. These discussions, however, do not bind a taxpayer or the tax administration to the APA process.

Usually there is one pre-filing meeting, but at times, depending on the level of complexities involved, there can be more than one pre-filing meeting, as the taxpayer and the APA Programme work together in developing a TPM which is founded on mutually agreeable principles. During the pre-filing meeting, the APA Programme team would usually provide their preliminary views and reactions to the issues involved as well as provide guidance on possible approaches that they would be more receptive to. At the same time, the APA Programme may also highlight any potential points of conflict and ask the taxpayer to work closely with the APA Programme while developing the detailed APA submission. This is aimed to avoid situations where the positions/ approaches proposed in the detailed APA submission prepared by the taxpayer prove to be a non-starter for the APA Programme.

Besides the APA team from the APA Programme, the taxpayer and its representatives, it is also helpful to have a representative from the Competent Authority office and from the field audit team at the initial pre-filing meeting. This allows the taxpayer to obtain initial reactions of both these parties that may have an influence on the APA process as well as the outcome.

It is advisable for the taxpayer to bring to the table as much information as possible, as it allows the APA Programme Team and others involved to fully react to the issues. To enable the taxpayers to be open during the discussions, the APA Programme should put controls in place that would not allow the tax administration to use the information shared in an undue manner. This would encourage a healthy discussion.

### APA Submission

As discussed above, the pre-filing meeting is a great source of critical information that can help further evaluate whether to pursue an APA or not. Based on the information gathered through the pre-filing meeting(s), the taxpayer can make the final decision.

The next logical step in the APA process is preparation and filing of the APA submission. By analogy, an APA submission is akin to transfer pricing documentation that is usually prepared for compliance purposes. It usually contains information such as the functional analysis, characterisation of the entities involved, industry analysis, selection and application of the most appropriate method, detailed financial analysis including the financial projections relied upon, etc.

The main points of differences between the APA submission and compliance documentation are:

- The APA submission is exhaustively detailed and addresses each of the sections in-depth
- The financial analysis heavily relies on the financial projections that form the basis of applying the selected TPM
- The TPM, while originally founded in the domestic transfer pricing provisions, in a bilateral/multilateral APA is likely to be more aligned to the OECD Guidelines such that it is acceptable to all the tax

administrations involved

- The APA submission would specify the proposed APA term along with any request for roll-back of the APA TPM to the open years
- Another significant point of difference is that the compliance documentation is generally prepared to provide penalty protection under the domestic transfer pricing legislation; whereas the APA submission is prepared with a view to reach an agreement with the tax administration

It is important for the APA submission to provide reasons, albeit implicitly, for the domestic tax administration to accept the proposed positions/approaches and sufficiently demonstrate why these positions are fair to the domestic revenue. In a bilateral/multilateral APA, simultaneously, the APA submission should strike a delicate balance to incorporate the points of consideration that are important for the foreign revenue.

While the tax administration may provide guidelines on what needs to be included in an APA submission, it could vary from case to case. The taxpayer should discuss with the relevant tax administration during the pre-filing meeting the critical documents and information that the tax administration would like to see as part of the APA submission.

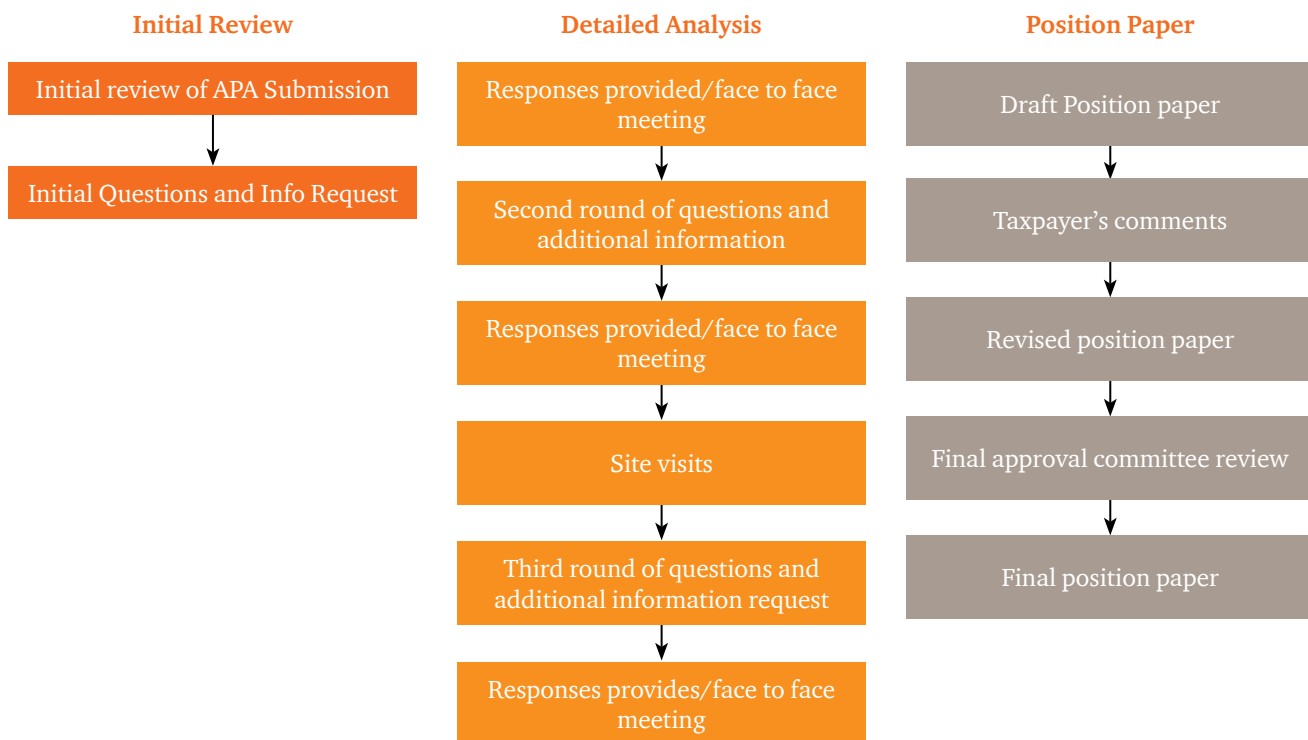
A well drafted and thorough APA submission would go a long way in significantly reducing the questions from the tax administrations involved as well as reducing the overall time involved in executing the APA.

The tax administration may provide for a timeline within which the APA submission should be filed from the date the taxpayer is communicated of the acceptance of the APA request by the APA Programme. It should also be clarified by when the APA submission must be filed to ensure coverage of a certain year within the APA term.

For a bilateral/multilateral APA, the submission must be filed simultaneously with all the tax administrations involved. Also, it is important for the content of the submissions filed with different tax administrations to be the same, though in certain cases there may be a request for a copy in the local language.

## Negotiation

Figure 9: Negotiation Process Flow



Upon filing the APA submission, the tax administration would review it in detail. Depending on the work load and the pendency of the case, it may take the APA team some time before they take up the case. However, within certain days from the filing of the APA submission, a formal team should be assigned to the case with whom the taxpayer can communicate to obtain regular updates and status of the case, as well as discuss any issues that may arise during that period. It is advisable for the APA team to comprise the same

members that were involved at the pre-filing meeting stage as it ensures continuity and provides natural synergies given that the taxpayer would have already build a certain level of relationship with those APA team members.

Usually the APA team would follow an internal timeline, which in some cases may even be shared with the taxpayer. The timeline is a framework within which the APA Programme would strive to work and conclude the APA.

Once the APA team starts reviewing the APA submission, there will be rounds of questions raised to obtain clarification and additional information as may be needed. These requests may be addressed through a combination of written responses and in-person meetings with the APA team. In the case of bilateral/multilateral APAs, any response provided or information shared with one tax administration must also be simultaneously shared with the other tax administrations involved even if it has not been specifically requested.

In addition to the rounds of questions, it is very helpful to organise site visits, especially in cases involving complex manufacturing operations, heavy use of fixed assets, intangible assets, etc. The site visits provide the APA team with a firsthand feel of the actual operations underlying the covered transactions, and makes it much easier for them to better understand and appreciate the business realities.

Towards the end of the above process, the APA team would prepare a draft position paper which may or may not be shared with the taxpayer. Usually, in a bilateral/multilateral APA process, such draft position paper is shared with the taxpayer and comments are sought prior to drafting the negotiating position.

Where the draft position paper is shared with the taxpayer, it should perform a close review and provide detailed comments including any points to which the taxpayer is not agreeable or has a

different position. These can also be discussed with the APA team in a face-to-face meeting.

The APA team will consider the taxpayer's comments and will then prepare a final position paper in the case of a unilateral APA, or a negotiating position paper in the case of a bilateral/multilateral APA, as the case may be. In either case, the position paper will be provided to the Final Approval Committee. Once an approval is obtained from the Final Approval Committee, it will become the basis of drafting the unilateral APA. In the case of a bilateral/multilateral APA, the negotiating position will then be provided to the Competent Authority for further negotiation with the Competent Authority of the other country involved.

### Competent Authority

This is more relevant for cases involving a bilateral/multilateral APA. Once the APA team finalises the negotiating position which has been approved by the Final Approval Committee, it is then handed over to the Competent Authority for its negotiations with the other Competent Authorities involved. In cases where the taxpayer has expressed reservations on the draft position paper prepared by the APA team, these should also be shared with the Competent Authority along with the final position paper to the extent not incorporated by the APA team in the final position paper. This is to ensure that the Competent Authority has full visibility into all the important points and arguments involved in the case.

The negotiating position serves as a starting point for the Competent Authority, who may request for additional information/clarification. The Competent Authority will then discuss and negotiate the process with the Competent Authorities of the other countries involved. Throughout this process, the taxpayer will

be closely involved and kept in the loop on the ongoing discussions, and so will the APA team. However, the Competent Authority discussion is a 'closed-door' process, and neither the APA team, nor the taxpayer can be present during those discussions. Also, the final agreement entered into between the two Competent Authorities is not made available to any other party.

The above process might lead one to believe that the Competent Authority's role starts only upon completion of the negotiation stage and once the negotiating position is ready. However, in practice, usually an analyst is assigned to the case from the Competent Authority office right from the beginning, as early in the process as the pre-filing meeting. The Competent Authority analyst closely follows the case throughout the process and is actively involved during the various stages of the process described above. This is also desirable from both the taxpayer and the tax administration perspective for the simple reason that in a bilateral/multilateral APA, it is important for the two or more Competent Authorities involved to have a good understanding of the case, as they will be ultimately deciding the final position to be adopted under the APA.

The taxpayer, throughout the APA process, must endeavour to ensure involvement of all the relevant Competent Authority analysts alongside the APA team members as it would significantly help in achieving a well reasoned outcome and would also tremendously help in making the process smooth.

### APA Execution

Upon completion of all the above steps, next comes the finalisation stage. This stage primarily consists of executing the signed APA, i.e., the agreement between the taxpayer and the one or more tax

administrations involved. The APA agreement, generally, is a short document that contains the following items:

- Brief background of the taxpayer (including technical details such as the tax identification number)
- Covered transactions
- Agreed TPM
- APA term including roll-back if applicable
- Critical assumptions
- Reporting requirements

A model APA agreement including annual reporting requirements is attached as Appendix A for the ready reference of readers.<sup>1</sup>

In addition, during this stage, the taxpayer and the tax administration would discuss the impact of the agreed TPM on the initial years of the APA term that have already passed. Usually, a compensatory adjustment is agreed between the parties involved based on the TPM and is either effected through revising the tax returns for these years, or through an adjustment in the current year tax return. Such compensatory adjustments are also usually made part of the agreement.

<sup>1</sup>The APA agreement and annual reporting requirement has been extracted from Canadian APA guidelines – Information Circular 194-4R dated 16 March 2001.

# Recommendations based on Best Practices

Having discussed the ‘nuts and bolts’ of the APA mechanism, this section provides recommendations to be considered in setting up an APA Programme. The thoughts and suggestions in this section are influenced by the best practices followed by various other jurisdictions, which were then tailored to reflect the need arising from the current transfer pricing scenario in India.

## Eligibility

There is no one size that can fit all when it comes to prescribing eligibility for an APA. In fact, the first question that needs to be answered is whether there should be any restriction on who can apply for an APA. The answer to this question depends on the need, facts and circumstances prevalent in different jurisdictions.

Various jurisdictions follow different practices for admission of an APA request. Some prescribe a monetary threshold for accepting an APA request which is computed based on the amount involved in the related party transactions proposed to be covered under the APA.

For example, China requires the annual amount of related party transactions proposed to be covered should be over RMB 40 million. On the other hand, the UK focuses on the degree of complexity involved in the transfer pricing issues proposed to be covered – it restricts acceptance of cases involving simplistic issues (however, there has been some

recent changes in this regard; this criteria has been relaxed in the latest draft revised APA manual of Her Majesty’s Revenue and Customs (HMRC). Both these criteria, in their own ways, attempt to restrict the number of APA applications accepted by these respective APA Programmes. This is mainly for two reasons – one is to achieve optimum benefits from the limited resources employed within the APA Programme; and secondly, to hedge the inherent risk carried by an APA, i.e., a fixed TPM for a period of five years.

From an Indian perspective, it would be advisable to use one or more filters/criteria to restrict the acceptance of APA applications. This can be justified based on the facts described below:

- During the last completed transfer pricing audit cycle, the tax authority made transfer pricing adjustments in more than 1,000 cases
- Cases are selected for transfer pricing audit through an automatic method of applying a threshold of INR 15 crores in intercompany transactions during the year
- It would be safe to estimate that in more than 90 percent of these cases, the taxpayers would end up in appeals, first at the tax department level, and then at the appellate tribunal level

If there is no threshold provided for accepting cases into an APA Programme, the above situation would guarantee failure of the APA Programme, by sheer overload, even before it can take stand up on its own.

Therefore, it would be advisable to provide certain eligibility criteria for accepting APA applications, which must be closely monitored, to ensure that the number of cases match the capacity of the APA Programme and is commensurate with its resource strength.

It is recommended that in addition to a monetary threshold which is pegged to the amount of intercompany transactions involved, one or more of the following

criteria must be considered for this purpose:

- Complexity of intercompany transactions involved
- Number of intercompany transactions involved, each of which might be simpler in nature, but when considered together, creates a complex situation
- Highly sensitive areas such as transfer of intellectual property, transfer of business, etc.

### Unilateral vs. Bilateral/ Multilateral APAs

Due to concerns over double taxation and to minimise taxpayer and governmental uncertainties and administrative costs, most countries including the UK, USA, Japan, Canada, etc. prefer bilateral or multilateral APAs over unilateral APAs. Furthermore, in certain jurisdictions, the taxpayer must show sufficient justification in the case it wishes to opt for a unilateral APA. For example, the USA and UK prefer bilateral APAs over unilateral APAs, unless there are good reasons to prove as to why another tax authority may not be included in the APA process, say if there is no appropriate tax treaty.

The real purpose of an APA, i.e., to provide certainty to taxpayers and eliminate double taxation, can only be achieved through bilateral APAs. In the case of unilateral APAs there is always a possibility of the other government not accepting the unilateral APA position.

That said, for intercompany transactions between non-treaty partner countries, unilateral APAs are helpful in providing certainty at least on one side of the equation. Another instance when it is useful to enter into a unilateral APA could be when a taxpayer has similar transactions with several countries. It would not be feasible to execute bilateral APAs with all the countries – in such a situation, the taxpayer, in consultation with the tax administration, may decide to

use a combination of bilateral and unilateral APA in the following manner:

- Execute a bilateral APA with one of the foreign countries (possibly with a more mature APA Programme)
- Execute a unilateral APA covering similar transactions with all other countries where the principle established in the bilateral APA can be adopted

Bilateral/multilateral APAs are particularly useful in the case of highly integrated business scenarios, cases involving complex transactions or cases involving intangibles, as in such cases it is pertinent to evaluate the result of TPM from both ends of the transactions.

Also, bilateral/multilateral APAs, by definition eliminate any possibility of double taxation and are better posed to achieve an arm's length result given that two or more tax administrations are involved and each of them wants to protect their revenue base.

While there can be situations where a unilateral APA might be preferable over a bilateral/multilateral APA, such situations are limited. More often than not, it would be in the interest of the tax authorities as well as the tax payers to enter into bilateral/multilateral APAs for the various reasons discussed above.

It is recommended that both bilateral and unilateral APAs should be introduced and encouraged by the Indian Revenue.

### Anonymous Pre-Filing Meeting

In certain jurisdictions such as the USA, UK, China, etc., the tax authority may allow the taxpayer to remain anonymous at the stage of a pre-filing meeting. Since APA would be a new concept in India, the taxpayers should be permitted to have a pre-filing meeting on an anonymous basis so that their apprehensions can be addressed and they can evaluate filing for an APA without any pressure.

### Collaborative Approach

APAs can provide an opportunity for both tax authorities and taxpayers to consult and cooperate in a non-adversarial environment. The opportunity to discuss complex tax issues in a less confrontational atmosphere can stimulate free flow of information among all parties, leading to a practicably workable outcome.

The kind of discussions that currently happen between the transfer pricing officers and the taxpayers cannot lead to a successful APA negotiation. It would help to establish the evaluation criteria of the APA team involved in the APA negotiation such that it further encourages the objectives of the APA Programme. In this regard, the following recommendations should be considered:

- The APA team's goal should be to collect the right amount of tax and help taxpayers achieve certainty;
- it should be appraised based on the quality of positions negotiated within a reasonable timeframe and not the quantum of additional tax revenue generated; and
- The APA Programme as a whole should also be made accountable for the number of APAs negotiated during a year.

### APA Team

In order to develop an effective APA Programme, the Indian government should have economists and industry experts on the APA negotiation panel. The APA team should be well trained and separate from the tax officers conducting transfer pricing audits. Unless this is ensured, the taxpayers would not perceive the APA team to be independent and would hesitate to share information.

A non-adversarial, cooperative environment is essential for a win-win solution. Furthermore, as discussed earlier, it is immensely important for the



APA Programme to maintain an independent status in terms of its thinking vis-a-vis the field audit team so that the APA team is, as well as perceived to be, independent of the field audit team by the taxpayers. This would help in ensuring voluntary disclosure by taxpayers during the APA process which can only be achieved by having a nationally centralised APA team. This would also go a long way in building a successful APA Programme in India.

### Time Limit for Negotiating an APA

APAs are case specific and need a significant amount of analysis before a final agreement can be reached between the taxpayer and the tax authorities involved. While it is difficult to put a rigid time limit for concluding an APA, there must be a recommendatory time limit for negotiating APAs. At an initial stage there should be a time limit of 18 months for negotiating a unilateral APA and 24 months for negotiating a bilateral APA.

The time limit for an APA renewal should be significantly less than the prescribed time limit for negotiating the original APA, especially if there are no major changes in the business model and facts and circumstances of the case.

### APA Term and Roll-Back

Generally, an APA is entered for the duration of three to five years and may be renewed/re-negotiated upon completion of the originally agreed term. Under the DTC, the APAs are proposed to cover terms up to a period of five years. However, if considerable time is spent in negotiating an APA, it should be allowed to continue for a minimum period of three years after signing of the APA agreement in order to avoid repetitive APA negotiations soon after agreeing the APA.

Certain countries have specific roll-back provisions and the taxpayer may request the tax administration to consider a

roll-back, along with the APA application. Even in the absence of a roll-back request, the tax administration may propose that the same or a similar TPM as agreed under the APA should be applied to the prior years. In the case of a bilateral APA, roll-back would also need the approval of the tax authority of the other country.

Looking at the current transfer pricing litigation scenario in India, it would be extremely helpful to incorporate roll-back provisions in the APA Programme. This would help in addressing the protracted litigation and provide an opportunity to the taxpayer and the tax authority to settle disputes in a congenial atmosphere.

### Withdrawal

Most tax authorities allow the taxpayers a flexibility to withdraw an APA application at any stage of the process. For instance, the taxpayer may withdraw the application if the negotiated position is not acceptable or the taxpayer does not see a point in agreeing to an APA because of a change in business circumstances.

Such an option should be available to the taxpayers under a well rounded APA Programme. The taxpayers should be assured that in such cases the information shared with the APA team would not be passed on to the tax officers who are responsible for conducting the transfer pricing audits. It is recommended that the Indian APA rules should also contain provisions on withdrawal of an APA application as this would induce confidence in the taxpayers.

### Information Requirement

Different APA regimes have different approaches regarding information requirements while filing an APA application. While China has a detailed prescribed list of documents that have to be filed along with the application, the UK takes a more flexible approach and there are no standard requirements while filing a formal application.

India may consider prescribing a list of documents that should be filed along with the APA submission. However, this requirement should be flexible and should be discussed upfront during the pre-filing stage between the taxpayer and the APA team. Through such discussion the relevant and necessary information can be identified for a particular case. Also, it would be a good idea to map the requirements with the existing documentation requirements for compliance purposes under the transfer pricing legislation.

### Critical Assumptions

In most jurisdictions, cancellation of an APA due to changes in facts or circumstances is extremely rare. In such cases, taxpayers and tax authorities are able to re-negotiate a mutually acceptable position by leveraging on the analysis already done while negotiating the APA in the first place. It is not uncommon for tax authorities to let an APA continue despite events such as mergers and acquisitions. The basic intent is to respect the time and resources spent in negotiating an APA.

With the above intention, the number of critical assumptions in an APA should be kept to a bare minimum and limited to factors that are absolutely critical for the continued application of the agreed TPM.

In this respect, the OECD Guidelines for conducting APAs under the Mutual Agreement Procedure also states that “...it may also be helpful to set parameters for an acceptable level of divergence for some assumptions in advance, in order to provide the necessary flexibility.”

It is important to mention that at present the APA regulations in the proposed DTC provide that the agreement shall not be binding if there is any amendment to the DTC having a bearing on the agreement so entered. However, the regulations do not discuss the impact of changes in the facts on the continuity of the APA. Since critical assumptions are important for the

continued application of an APA, it is advisable that the APA rules should provide necessary guidance to set critical assumptions in a broad manner so that every small change in facts or law does not lead to a time consuming re-negotiation or cancellation of an APA.

### Confidentiality

While negotiating APAs, the taxpayers may have to submit sensitive information such as future business projections, marketing strategy, audited financials etc. Most of the APA regimes have confidentiality provisions in their APA Programme to ensure that at no stage the information submitted by the taxpayer is shared with any other government department, especially tax officers auditing open years without the taxpayer's prior consent.

The Indian APA Programme should have robust confidentiality provisions to safeguard the interests of the taxpayer. The information shared by the taxpayer should not be shared with revenue officers auditing open tax years regardless of the outcome of APA negotiations.

### Annual Reporting

Taxpayers are required to submit reports demonstrating compliance with the terms of the APA on an annual basis within a specified time frame. For example, in Japan, the APA Annual Reports are required to be filed no later than the prescribed tax return filing due date for the relevant year. Similarly, the US also requires an APA Annual Report to be filed within a specified timeframe. On the other hand, the UK has no documentation rules regarding APAs.

Reduction in annual compliance burden is another major consideration for companies to opt for an APA. Since all the relevant information is already part of the APA negotiation process, the annual documentation should be limited to information that supports compliance with the APA terms.

The prescribed annual transfer pricing reporting requirement under an APA should be less complex and less onerous than the documentation requirement under the existing transfer pricing legislation. To the extent possible, efforts should be made to customise the requirement for a specific APA instead of a standard list of requirements for all taxpayers that enter into an APA.

### APA Fees

The basic purpose of charging a fee is to provide sufficient resources to conclude an APA in an acceptable time frame. Taxpayers generally do not mind paying a reasonable fee to accelerate the process. Moreover, countries that provide better resources for APA negotiation are able to achieve a better position as compared to their less prepared counterparts.

The Indian APA Programme should consider charging a fee commensurate with the size of the taxpayer/value of intercompany transactions involved so that suitable resources can be allocated for conclusion of the APA in a reasonable timeframe. Allocation of well trained and skilled resources would also help in protecting the interests of the Indian Revenue.

# Points to Ponder

## Initial APA Years – Approach and Documentation Requirement

The initial years under a proposed APA are very critical. During these years, the APA is still under negotiation and usually there is no, or limited, guidance from the tax administration on what approach should be followed by the taxpayer while its APA application is being processed. Several questions need to be addressed:

- Should the taxpayer continue to follow the same approach as in the prior years, or should it follow the approach proposed in the APA application?
- Should the taxpayer maintain the rigorous documentation as prescribed under the normal transfer pricing legislation, or should reliance be put on the information filed as part of the APA submission?
- What should be the basis of preparing the tax return for these years in the home country and in the overseas jurisdiction in the case of a bilateral APA?
- How should the sufficiency of the tax reserves relating to the proposed covered transactions under the impending APA be evaluated?

These and several other similar questions have to be addressed case by case. There might not be sufficient guidance from any corner that would provide standard answers to these questions.

## APA Applicability

Since an APA is concluded by the taxpayers and the tax administration of one or more jurisdictions keeping in view the particular facts of the case, it is applicable to

- For that taxpayer
- For the covered transactions
- For the APA term

An APA is different in its scope from judicial pronouncements as they primarily answer questions of law and the applicability of those judgments to any particular case is dependent upon the facts of each case. Therefore, an outcome reached under an APA cannot have any persuasive value except in the same case while rolling-back the approach, to the extent the facts and circumstances support such application.

Taxpayer specific APA results are not published in the public domain, though many tax authorities publish annual reports on APA statistics which can provide guidance to taxpayers.

## APAs in Economic Downturn

APAs are very well suited for addressing transfer pricing issues during an economic downturn. This is mainly for the reason that it provides flexible ways in which a transfer pricing issue may be approached. For example, appropriate and necessary adjustments can be proposed and agreed upfront between the taxpayer and the tax authorities to reflect the peculiar economic conditions. Below is a list of some of the ways through which this can be achieved:

- Comparable company selection
- Lengthening time horizon for historical analysis
- Possible use of full range
- Shifting time horizon to include previous economic downturns
- Rolling multi-year averages
- Term test
- Develop appropriate critical assumptions

# Worldwide Perspective – Country Chapters

The brief country wide analyses of APA provisions are given in the table below:

Description	Australia	Canada	China
Legal Requirements	No Specific legislation. Basis for agreeing an APA is pursuant to administrative powers under Australian legislation (for unilateral APAs) and the Mutual Agreement Procedure (MAP) under Australia's Double Taxation Agreements (for bilateral and multilateral APAs).	IC 94-4R dated 16 March 2001, outlines the procedures and guidelines for obtaining APAs in Canada and provides comprehensive guidance on APAs. IC 94-4RSR (Special Release) discusses APAs for small businesses.	China's legislation includes various articles of the Corporate Income Tax Law, Implementation Regulations of the Administration of Tax Collection Law, Circular Guoshuifa etc.
Time to Conclude	Australian Taxation Office (ATO) has set itself an internal target to complete unilateral APAs in 12 months and bilateral in 24 months.	Time needed to process an APA request depends upon the scope and complexity of a case.	It usually takes the tax authorities 8 to 12 months to complete unilateral APAs.
Type of APAs	Unilateral, Bilateral (and Multilateral) APAs.	Unilateral, Bilateral (and Multilateral) APAs.	Unilateral, Bilateral (and Multilateral) APAs. Initially higher no. of unilateral APAs. Increasingly Bilateral APAs concluded.
Validity Period	Between 3 to 5 years.	Between three to five years.	3 to 5 consecutive years.
Cost of Filing an APA	No application/filing fee.	Cost involved outlined in an APA acceptance letter, Small Business Taxpayer – CAD 5,000	No application/filing fee.

Description	Japan	U.K.	U.S.A
Legal Requirements	Transfer Pricing enforcement is governed by Special Taxation Measures Law (STML), and STML Enforcement Orders. Guidelines regarding APA and MAP procedures have been issued through subsidiary administrative procedures.	Section 85 to 87 of the Finance Act 1999 governs the APA regime. The legislation is supported by a Statement of Practice (SP 3/99) issued by HMRC.	The procedures for requesting an APA are set forth in IRS, Revenue Procedure 2006-9, amended Rev. Proc. 2008-31. These are governed by Section 482 of Internal Revenue code.
Time to Conclude	A unilateral APA may take one year or longer to conclude. Preparations of Bilateral APA submission may take six months to a year and completion may take longer.	HMRC has an objective of completing APA negotiations within a timeframe of 18-21 months.	APA Programme aspires to conclude cases within 12 months (Unilateral) and nine months (Bilateral). However, it took 23.6 months (Unilateral) and 45.6 months (Multilateral/Bilateral) for APAs to be completed in 2009.
Type of APAs	Unilateral, Bilateral (and Multilateral) APAs.	Unilateral, Bilateral (and Multilateral) APAs. Normally prefers Bilateral APAs, unless there are good reasons why another tax authority cannot be included.	Unilateral, Bilateral (and Multilateral) APAs. In practice, the majority of the APAs are Bilateral.
Validity Period	Between three to five years.		Minimum five years. But shorter term may be agreed upon between the IRS and the taxpayer.
Cost of Filing an APA	No application/filing fee.	No application/filing fee.	Filing new APA request – USD 50,000 Small Business Taxpayer – USD 22,500

Separate chapters for each the above countries have been provided as Appendix B for the readers to enhance the understanding of the APA process in these countries.

## Appendix A – Model APA agreement including annual reporting requirements<sup>2</sup>

### Example of an APA (Tangible Property)

The following APA is an example only. Each APA is unique and the terms and conditions may vary from those indicated in this appendix.

**ADVANCE PRICING ARRANGEMENT**

**between**

**[NAME OF THE CANADIAN TAXPAYER]**

**and**

**THE MINISTER OF NATIONAL REVENUE**

<sup>2</sup> The APA agreement and annual reporting requirement has been extracted from Canadian APA guidelines – Information Circular 94-4R dated 16 March 2001.

## ADVANCE PRICING ARRANGEMENT

between

[NAME OF THE CANADIAN TAXPAYER]

and

THE MINISTER OF NATIONAL REVENUE

This advance pricing arrangement (APA) is between [NAME OF THE CANADIAN TAXPAYER] (the “taxpayer”) and the Minister of National Revenue, through the Minister’s authorized representative, the Director General, International Tax Directorate.

### 1. BACKGROUND

The taxpayer is the [Canadian parent/subsidiary] of [NAME OF THE NON-RESIDENT ENTITY], a [NAME OF STATE/COUNTRY] foreign corporation.

[DESCRIBE THE BUSINESS OF THE TAXPAYER AND THE NON-RESIDENT ENTITY’S BUSINESS]

The taxpayer and the Minister of National Revenue (the “parties”) wish to establish a methodology to determine the transfer prices charged for the covered transactions that will constitute arm’s-length transfer prices for the purposes of section 247 of the Canadian Income Tax Act (the “Act”). The terms of this APA are consistent with the related competent authority agreement reached between the Canadian competent authority and the [NAME OF THE FOREIGN COMPETENT AUTHORITY] dated [DATE OF THE BAPA] pursuant to Article [NUMBER] of the [NAME OF THE RELEVANT CONVENTION].

The parties agree as follows:

### 2. DEFINITIONS

For purposes of this APA, the terms and expressions listed below shall have the following meaning:

**APA** – This advance pricing arrangement.

**APA request** – The taxpayer’s request dated [DATE] for an advance pricing arrangement, including the APA submission and any additional representations (oral or written), information, and supporting documents presented.

**APA years** – All taxation years of the taxpayer to be covered by this APA, the first one beginning on [DATE] and the last one ending on [DATE].

**CCRA** – The Canada Customs and Revenue Agency.

**Convention** – [NAME OF THE RELEVANT CONVENTION].

**Critical assumption** – Any assumed objective criterion that would significantly affect the substantive terms of the APA if the underlying conditions changed, whether or not the change is within the taxpayer’s control.

**Director General** – The Director General, International Tax Directorate, of the CCRA, or the Director General’s designate.

**[NAME OF THE FOREIGN TAX ADMINISTRATION]** APA – The advance pricing arrangement between the **[NAME OF THE FOREIGN TAX ADMINISTRATION]** and **[NAME OF THE NON-RESIDENT ENTITY]** that is intended to reflect the related competent authority agreement between the Canadian competent authority and the **[NAME OF THE FOREIGN COMPETENT AUTHORITY]** dated **[DATE OF BAPA]**.

**TSO** – A tax services office of the CCRA.

### **3. COVERED TRANSACTIONS AND TERM**

This APA covers the following transactions between the taxpayer and **[NAME OF THE NON-RESIDENT ENTITY]** for the APA years:

*[LIST THE COVERED TRANSACTIONS]*

### **4. THE METHODOLOGY AND ITS APPLICATION**

The transfer prices charged in respect of the covered transactions shall be determined by the taxpayer in accordance with the following transfer pricing methodology (TPM):

*[DESCRIBE THE TPM]*

Amounts used under this TPM will be calculated, expressed, and paid in **[NAME OF THE CURRENCY]** or the equivalent. Foreign currency will be converted in accordance with **[DESCRIBE]**.

### **5. EFFECT OF THE APA**

If the transfer prices charged for the covered transactions for an APA year have been determined by the taxpayer in accordance with the TPM, and the taxpayer has complied with the terms and conditions of this APA, the CCRA will consider that those transfer prices for that year are arm's length transfer prices for the purposes of section 247 of the Act.

### **6. CRITICAL ASSUMPTIONS**

For the purposes of this APA, the following critical assumptions apply:

- (a) the business activities and accounting policies and practices of the taxpayer and **[NAME OF THE NON-RESIDENT ENTITY]** shall remain substantially the same as described in the APA request;
- (b) *[LIST OTHER CRITICAL ASSUMPTIONS]*

If there is a failure to meet a critical assumption, the taxpayer must notify the Director General in writing within **[NUMBER]** days of becoming aware of the failure.

### **7. APA REPORTING**

For each APA year, the taxpayer shall file with the Director General and the **[NAME OF THE FOREIGN TAX ADMINISTRATION]** an annual report describing the taxpayer's and **[NAME OF THE NON-RESIDENT ENTITY]**'s actual operations for the year and demonstrating the extent of the taxpayer's and **[NAME OF THE NON-RESIDENT ENTITY]**'s compliance with the terms and conditions of this APA. The annual report is to include all items called for by this APA, and any requests to the Director General to revise or cancel this APA.

Each annual report is to include the following items:

- 1. a copy of the relevant **[audited]** financial statements of the taxpayer and **[NAME OF THE NON-RESIDENT ENTITY]** for that APA year;
- 2. a copy of all management and certification letters issued to the taxpayer or to **[NAME OF THE NON-RESIDENT ENTITY]** by **[independent auditors/accountants]** with respect to their **[examination/review]** of operations or **[audit/compilation]** of the financial statements of the taxpayer and **[NAME OF THE NON-RESIDENT ENTITY]** for that APA year, pertinent to any aspect of the determination of the transfer prices with respect to the covered transactions or compliance with the terms and conditions of this APA;



3. a copy of CCRA Form T106 and [equivalent forms of the [NAME OF THE FOREIGN TAX ADMINISTRATION] and accompanying schedules] reporting the covered transactions for the relevant APA year and an accounting of any differences between amounts required to be reported respectively by the taxpayer and [NAME OF THE NON-RESIDENT ENTITY] on those forms and the corresponding amounts reported by the taxpayer and [NAME OF THE NON-RESIDENT ENTITY] in their financial statements for that APA year;
4. a description of any material changes in financial or tax accounting methods or principles employed for that APA year in respect of the covered transactions that differ from the financial or tax accounting methods employed and reflected in the APA request, or if in the taxpayer's opinion, there were no such material changes, an affirmative statement to that effect;
5. a description of any failure to meet a critical assumption, and the reasons therefor or, if there have been no such failures, a statement to that effect, as well as a statement on the continuing relevance of the critical assumptions;
6. a statement identifying all material differences between the description of the taxpayer's business operations contained in the APA request and the taxpayer's business operations for that APA year, or if in the taxpayer's opinion there were no material differences, an affirmative statement to that effect;
7. all appropriate information and computations necessary to describe and support the application of the TPM to the covered transactions and the results for that APA year, demonstrating the compliance with the TPM;
8. an analysis and accounting of any compensating adjustments or subsequent compensating adjustments required under this APA, and the manner in which the related payments were, or will be, made; and
9. other items as may be appropriate to the particular circumstances of the taxpayer and [NAME OF THE NON-RESIDENT ENTITY].

The first annual report will also include a copy of the APA entered into between the [NAME OF THE FOREIGN TAX ADMINISTRATION] and [NAME OF THE NON-RESIDENT ENTITY].

In the event that one or more APA years have elapsed prior to the signing of this APA, the original and two copies of each annual report are to be filed with the Director General within [NUMBER] days from the date of the taxpayer's signature of this APA. The original and two copies of each annual report for other APA years are to be filed with the Director General and the [NAME OF THE FOREIGN TAX ADMINISTRATION] no later than [NUMBER] days after the end of the relevant APA year. Failure to comply with the annual report filing requirements, as set out above, may result in the cancellation of this APA.

Any clarification or additional information requested by the CCRA is to be supplied by the date specified or as extended by the CCRA.

## 8. APA AUDIT

TSO audits with respect to the covered transactions of an APA year will generally be limited to verifying that:

- the terms and conditions of this APA have been complied with;
- material representations in the APA request, related submissions, and the annual reports remain valid and accurately describe the operations of the taxpayer and [NAME OF THE NON-RESIDENT ENTITY];
- the taxpayer applied the TPM consistently in accordance with the terms and conditions of this APA;
- supporting data and calculations used in applying the TPM were correct in all material respects; and
- the critical assumptions underlying this APA remain valid and relevant.

If a TSO determines that any matter outlined above has not been resolved, the TSO will consult with the Director General.

The TSO may, after appropriate consultation with the Director General, propose adjustments to give effect to this APA or propose usual and routine audit adjustments to the determination and computation of the taxpayer's income and transfer prices reported for the purposes of the covered transactions during the taxation year or years under audit as determined in accordance with this APA. Such proposed adjustments will not affect the continuing validity or applicability of this APA. If the taxpayer agrees with such proposed adjustments, they will be treated as subsequent compensating adjustments in accordance with section 10 of this APA. If the taxpayer does not agree with the proposed adjustments, the taxpayer may refer the matter to the Director General for resolution in accordance with section 11 of this APA.

## 9. RECORD RETENTION

In addition to its obligations under the Act, the taxpayer must maintain sufficient books, records, and other information to enable the CCRA to determine the extent of the taxpayer's compliance with this APA.

Information requested by a TSO during an APA audit must be made available to the TSO within [NUMBER] days of a written request. If additional time is needed, an appropriate extension of time may be granted by the CCRA upon written request within this [NUMBER]-day period.

Should the TSO's request involve materials that are not in the English or French language, the TSO may request a translation. The translation shall be provided to the TSO within [NUMBER] days of such request. An appropriate extension of time may be granted by the CCRA upon written request.

## 10. COMPENSATING ADJUSTMENTS

In the event that one or more APA years have elapsed and the appropriate Canadian federal income tax returns have been filed prior to the signing of this APA, amended Canadian federal income tax returns shall be filed, as necessary, within [NUMBER] days from the date of the taxpayer's signature of this APA reflecting the application of the TPM. Any resulting compensating adjustment required to bring the previously filed returns in agreement with the amounts determined by the application of the TPM for each APA year must be paid to the appropriate entity within this period.

For APA years that have not elapsed before the signing of this APA, to the extent that a compensating adjustment is necessary, the taxpayer or [NAME OF THE NON-RESIDENT ENTITY], as the case may be, shall pay the required compensating adjustment within one hundred and eighty (180) days from the end of the paying entity's taxation year to which the compensating adjustment relates.

A subsequent compensating adjustment may arise when, after the filing of a tax return for an APA year, the taxpayer or the CCRA makes usual and routine adjustments (e.g., correction of mathematical errors) to the determination and computation of the transfer prices for that APA year in accordance with this APA. Any subsequent compensating adjustments proposed by the CCRA and agreed to by the taxpayer must be paid within ninety (90) days from the date of the reassessment. When a subsequent compensating adjustment arises as a result of a proposal by the [NAME OF THE FOREIGN TAX ADMINISTRATION], the taxpayer will provide notice to the CCRA within ninety (90) days from the date of the proposal.

The taxable income of the taxpayer for an APA year will take into account all compensating adjustments and subsequent compensating adjustments, as computed in accordance with this APA, and will be used for all Canadian federal income tax purposes (including foreign tax credits and withholding taxes if the underlying nature of the adjustment requires these). A liability arising from a compensating adjustment or subsequent compensating adjustment will be deemed to accrue as of the last day of the APA year to which it relates, and will be taken into account for interest purposes and in the computation of any required tax instalments for that APA year or subsequent taxation years.

The taxpayer and [NAME OF THE NON-RESIDENT ENTITY] will settle compensating adjustments or subsequent compensating adjustments by [METHOD OF PAYMENT]. Payments of compensating adjustments or subsequent compensating adjustments are to be made in the currency in which payments between the taxpayer and [NAME OF THE NON-RESIDENT ENTITY] are made for the covered transactions.

## 11. DISPUTE RESOLUTION

Any dispute arising under this APA shall be resolved by the Director General who may, inter alia:

- have the TSO abide by the terms of this APA as interpreted by the Director General;
- revise this APA with the concurrence of the taxpayer;
- cancel this APA; or
- revoke this APA

in accordance with the relevant procedures set out in sections 13 through 15 of this APA.

Without limiting the generality of the foregoing, and by way of example only, disputes with respect to, inter alia, the interpretation of any term of this APA, whether a given transaction is a covered transaction, whether the taxpayer has complied with the record retention requirements, and whether the APA should be either revoked or cancelled are all disputes that shall be resolved as set out above by the Director General. The Director General's decision will be final. Nothing in this APA shall be read or construed as restricting the jurisdiction of the Tax Court of Canada under Part I, Division J of the Act should the taxpayer wish to appeal an assessment or reassessment for an APA year as if this APA had never existed.

## 12. USE, DISCLOSURE, AND PROTECTION OF INFORMATION

APAs and the information that the CCRA obtains or generates during the APA process, including commercially sensitive and proprietary data is provided for the purposes of administering the Act. Consequently, the confidentiality provisions of the Act and the Convention limit the rights and powers of the CCRA to use and disclose information submitted in connection with an APA. Accordingly, the CCRA may employ information obtained or generated during the processing of this APA in reassessing taxation years not covered by this APA or for transactions not expressly included as part of the covered transactions under this APA.

Except as otherwise provided by written agreement, this APA may not be introduced by the Taxpayer or the CCRA as evidence in any administrative or judicial proceeding in relation to any taxation year, transaction, or person.

## 13. REVISION OF THIS APA

This APA may be revised if it is established that:

- there has been a failure to meet a critical assumption;
- there has been a change in law or to the Convention that modifies the Canadian federal income tax treatment of any matter covered by this APA; or
- there has been a material change in circumstances, as established through the filing of annual reports or the audit by a TSO of any of the APA years, or any other means.

If the taxpayer believes that this APA requires revision, the taxpayer shall notify the Director General. The notice shall be filed promptly, specify the reason for the revision, and shall include supporting documentation.

The taxpayer and the Director General will discuss how this APA may be revised. If the Director General and the taxpayer agree on a revised advance pricing arrangement, the effective date of that arrangement will be stated in that advance pricing arrangement. If the parties fail to sign a revised advance pricing arrangement, the Director General may cancel this APA.

If the Director General and the taxpayer agree to revise this APA, the Canadian competent authority will seek concurrence for the revision from the [NAME OF THE FOREIGN COMPETENT AUTHORITY]. In the event that the [NAME OF THE FOREIGN COMPETENT AUTHORITY] does not agree on the revision, the Director General may:

- continue to apply this APA;
- apply the revised APA; or
- cancel this APA.

## 14. CANCELLATION OF THIS APA

The Director General may cancel this APA, if it is established that:

- the taxpayer or [NAME OF THE NON-RESIDENT ENTITY] has made any material misrepresentation, mistake, or omission in the APA request or an annual report or renewal submissions with respect to this APA or in supplying, or failing to supply, any relevant information with respect to this APA;
- the taxpayer or [NAME OF THE NON-RESIDENT ENTITY] failed to comply with any material term or condition of this APA;
- there has been a failure to meet a critical assumption;
- there has been a change in law or to the Convention that modifies the Canadian federal income tax treatment of any matter covered by this APA; or
- there has been a failure to sign a revised APA.

If this APA is cancelled:

- the taxpayer will be provided with a written statement specifying the grounds for the cancellation;

- the [NAME OF THE FOREIGN COMPETENT AUTHORITY] will be informed;
- the cancellation usually will be effective as of the beginning of the taxation year which relates to the circumstances listed in the preceding paragraph;
- this APA will cease to be of any further force and effect with respect to the taxpayer and the Minister of National Revenue, as of the effective date of the cancellation; and
- after the effective date of the cancellation, the transactions previously covered by the APA will be subject to the provisions of the Act and the Convention.

#### 15. REVOCATION OF THIS APA

The Director General may revoke this APA if it is established that:

- the taxpayer or [NAME OF THE NON-RESIDENT ENTITY] has made any material misrepresentation that is attributable to neglect, carelessness, or willful default in the APA request, an annual report, or renewal submissions with respect to this APA or in supplying, or failing to supply, any relevant information with respect to this APA; or
- the taxpayer or [NAME OF THE NON-RESIDENT ENTITY] failed to comply with any material term or condition of this APA.

If this APA is revoked:

- the taxpayer will be provided with a written statement specifying the grounds for the revocation;
- the [NAME OF THE FOREIGN COMPETENT AUTHORITY] will be informed of such revocation;
- such revocation will be effective from the first day of the first APA year, and this APA will be of no force and effect with respect to the taxpayer and the Minister of National Revenue as though it had never been signed;
- the transactions previously covered by the APA will be subject to the provisions of the Act and the Convention.

#### 16. CHANGE IN THE FOREIGN TAX ADMINISTRATION'S APA

If the [NAME OF THE FOREIGN TAX ADMINISTRATION]'s APA is not consistent with this APA or has been revised, cancelled, or revoked, the taxpayer shall notify the Director General within [NUMBER] days of becoming aware of such inconsistency or action. After the Canadian competent authority consults with the [NAME OF THE FOREIGN COMPETENT AUTHORITY], the Director General may:

- continue to apply this APA;
- revise this APA with the concurrence of the taxpayer;
- cancel this APA; or
- revoke this APA.

#### 17. RENEWAL

Requests for renewal of this APA should be directed to the Director General and follow the form and procedures and comply with the requirements that apply to an initial request for an advance pricing arrangement that are in effect at the time the request for renewal is made.

#### 18. CHANGE IN LAW OR TO THE CONVENTION

If there is a change in law or to the Convention that modifies the Canadian federal income tax treatment of any matter covered by this APA, the new or amended law or the Convention will supersede this APA to the extent that it is inconsistent.

**19. NOTICE**

Any notices (or notifications) required by this APA shall be made in writing.

Notices to the Director General shall be addressed as follows:

Director General  
International Tax Directorate  
Canada Customs and Revenue Agency  
5th floor  
344 Slater Street  
Ottawa ON K1A 0L5  
CANADA  
Attention: Director, Competent Authority Services Division

or to such other representative or address as specified by written notice to the taxpayer.

Notices to the taxpayer shall be addressed as follows:

[NAME OF THE CANADIAN TAXPAYER]  
Attention: [NAME OF APPROPRIATE OFFICER]  
[ADDRESS OF THE TAXPAYER]

or to such other representative or address as specified by written notice to the Director General.

**20. PENALTIES**

As long as this APA remains in effect and the taxpayer complies with the terms and conditions of this APA, no transfer pricing penalty under subsection 247(3) of the Act will be assessed with respect to the covered transactions.

**21. COUNTERPARTS**

This APA may be signed in counterparts, with each counterpart deemed an original.

**22. MISCELLANEOUS**

This APA constitutes the entire arrangement between the parties and, except as otherwise provided, no written or oral understandings or representations pre-dating the signing of this APA shall be of any effect. Except as otherwise provided, this APA may not be varied, amended, or supplemented except by written instrument signed by the parties.

IN WITNESS WHEREOF the parties have signed this APA on the dates indicated below.

[NAME OF THE TAXPAYER]

By:

\_\_\_\_\_  
Date

\_\_\_\_\_  
[NAME OF THE REPRESENTATIVE] [TITLE]

THE MINISTER OF NATIONAL REVENUE

By:

\_\_\_\_\_  
Date

\_\_\_\_\_  
[NAME OF THE OFFICIAL]  
Director General  
International Tax Directorate  
Canada Customs and Revenue Agency

*Country Chapter*  
***Australia***



***Helen Fazzino***

Partner, PwC  
Transfer Pricing (Australia)  
Email: [helen.fazzino@au.pwc.com](mailto:helen.fazzino@au.pwc.com)

Helen is PwC Melbourne Tax Leader and a member of the PwC Global Transfer Pricing Leadership Group.

Helen provides effective transfer pricing planning, oversees the management of compliance and transfer pricing documentation, and assists in developing audit defence strategies. She has 22 years of experience in corporate tax, specialising in transfer pricing since 1996.

## Overview

The Advance Pricing Arrangement (APA) Programme is well established in Australia, having been in operation for almost two decades.

The Australian Taxation Office (ATO) has considerable experience in unilateral, bilateral and multilateral APAs and continues to support and promote its APA Programme as part of its wider transfer pricing compliance programme. In recent times the ATO has been evaluating and further tailoring its APA Programme to cater for current business and associated transfer pricing issues.

## Legislation – APA

There is no specific legislation which details Australia's APA Programme. The basis for agreeing an APA is pursuant to the Australian Commissioner of Taxation's general administrative powers under Australian legislation (for unilateral APAs) and the Mutual Agreement Procedure under Australia's Double Taxation Agreements (for bilateral and multilateral APAs).

An APA applies to transactions, agreements or arrangements that are relevant for the purposes of Australia's domestic transfer pricing laws (Division 13 of Part III of the Income Tax Assessment Act 1936). The ATO agrees not to make any adjustments (to the covered transactions) under Division 13 for the duration of the APA, provided the taxpayer complies with the terms and conditions of the APA.

## Year of implementation

Australia's APA Programme started in 1992. Australia completed the first ever bilateral APA globally – the 'Apple' APA with the USA. Since its inception, Australia has completed approximately 160 APAs (although some have been now cancelled or renewed several times).

Australia has negotiated bilateral / multilateral APAs with a number of countries, including Japan, USA, Canada, Korea, Germany, Denmark, New Zealand, the United Kingdom and Switzerland.

## Scope of APA regulations

A taxpayer may obtain an APA regarding the application of a methodology to its related party transactions, agreements or arrangements with its foreign affiliates. A taxpayer includes both legal entities and permanent establishments that either have or are contemplating international transactions that involve Australia. Taxpayers may apply for either a unilateral, bilateral or multilateral APA.

While there is no legislation covering APAs, the ATO has issued Taxation Ruling TR 95/23 as well as a public booklet outlining the procedures for Australian APAs. Combined, these pronouncements give guidance to taxpayers on the ATO's views on various aspects of APAs and the broader APA Programme including:

- The benefits of an APA;
- The types of APAs (unilateral, bilateral and multilateral);
- What information a taxpayer needs to include in their APA application; and
- The five step process the ATO undertakes to evaluate an APA.

Whilst an APA itself is not legally binding on the taxpayer, under TR 95/23, the ATO states that it will not make any adjustments to the transfer pricing method used by the taxpayer provided the taxpayer complies with the terms and conditions of the APA.

Australian APAs are of limited duration, typically 5 years with an option to extend the APA after that period.

## Administrative practices

(Note: The administrative practices for APAs in Australia are currently being examined by the ATO, following the PwC review of the APA Programme in Australia. It is not expected, however, that the framework described below will change materially)

- Procedures for filing an APA request
- In Australia, unilateral, bilateral and multilateral APAs follow the same 5 step process.



The purpose of prelodgment meetings is for the taxpayer and the ATO to discuss, at a high level, the nature and scope of the APA. This includes consideration of the transactions involved, whether the APA will be unilateral, bilateral or multilateral, the proposed transfer pricing method, required documentation and information, a proposed timetable for the process and other scoping items.

Following the prelodgment meetings, the taxpayer can lodge a formal APA application, which will generally include:

- Details of the proposed transfer pricing method and supporting information;
- Proposed terms and conditions governing the application of the transfer pricing method;
- Data showing that the transfer pricing method will produce arm's length results;
- A discussion and analysis on critical assumptions; and
- A suggested term of the APA.
  - Cost involved in filing an APA application

There are no fees or charges to lodge and negotiate an APA application in Australia.

- Time lines for negotiating an APA

The ATO has set itself an internal target of 12 months to complete a unilateral APA and 24 months to complete a bilateral APA, post the pre-lodgment phase and formal application of the APA. In PwC's experience, the prelodgment stage can range anywhere from a few months to 1-2 years depending on the complexity of the APA.

- Provision for roll back

APAs generally have prospective application, however, in PwC's experience the outcome of an APA can be rolled back into prior years and is regularly used as a technique by the ATO and taxpayers to resolve prior year issues in a more co-operative environment than that of an audit. There are no formal rules covering roll back.

- Streamlined APAs

The ATO is currently developing a streamlined APA process for taxpayers with low levels of related party dealings and this will be covered in the release of APA Guidance in the near future (see below). In practice, the streamlined approach is already being used by the taxpayers and the ATO.

## Post agreement documentation rules

In Australia, the taxpayer must prepare and submit an Annual Compliance Report (ACR) for each year of the APA. Whilst the specifics may be agreed as part of a particular APA, typically an ACR will outline/include:

- Any material changes to the business of the taxpayer, the structure/relationship of the parties involved in the covered transactions or the financial or tax accounting methods concerning the covered transactions;
- Whether the terms and conditions of the APA have been complied with including whether any critical assumptions agreed in the APA have not been met;
- A copy of the audited financial statements of the taxpayer;

- A copy of the income tax return of the taxpayer;
- An analysis of any abnormal items incurred or derived by the taxpayer;
- All appropriate information and computations necessary to describe the application of the taxpayers results to the agreed transfer pricing method and any compensating adjustments required; and
- Reconciliation between accounting and taxable income.

## Country specific issues / latest developments

In late 2007 the ATO commissioned PwC Australia to review and evaluate Australia's APA Programme and to provide feedback and recommendations. It had been recognised, both within the ATO and by external stakeholders, that the programme needed some refinement (mainly due to transfer pricing issues maturing and becoming more complex and increased taxpayer demand for certainty through APAs).

The review involved seeking feedback from a variety of stakeholders including



ATO personnel, Australian and foreign taxpayers, advisors and industry groups.

The objectives of PwC's recommendations were to build capability within the ATO and to increase taxpayer confidence in the APA Programme. The key recommendations included increased sharing of information between the ATO and taxpayers, preparation of and adherence to detailed project plans, establishing a circuit-breaker if APA negotiations reach a stalemate and increasing the technical capability of ATO personnel involved in APAs.

The ATO broadly agreed with the majority of PwC's recommendations and has made a concerted effort to improve its APA Programme with the overarching aim of developing a programme that is capable of dealing with the demands and complexities of current and future business issues. The ATO established a Co Design Committee comprising of ATO personnel and representatives from professional associations and they are in the final stages of designing and implementing revised approaches to Australia's APA Programme.

It is expected that the ATO will issue updated APA Guidance by the end of March 2011. At that time Taxation Ruling TR 95/23 will be withdrawn.

### Key learning

In the last two decades APAs have become an important feature in Australia's transfer pricing landscape. APAs are used by multinationals to manage their transfer pricing risk and provide comfort on a prospective basis, particularly where the issues are complex and uncertain.

APAs are a valuable cooperative process between the taxpayer and the ATO and typically involve less compliance costs than that of an audit.

The ATO continues to support its APA

Programme and is progressively negotiating APAs with new jurisdictions. In addition, the ATO is currently making improvements to its programme to cater for the demands of both today and tomorrow's business issues. This, coupled with continued support by taxpayers, will ensure a positive and constructive future for Australia's APA Programme

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**Country Chapter**  
**Canada**



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Martin's specialization is managing transfer pricing engagements for large multinational companies, focusing on dispute resolution involving audits, the Competent Authority process, Advance Pricing Agreements and voluntary disclosures. Martin has successfully negotiated 12 APAs (unilateral and bilateral). He also assists clients with developing and implementing tax planning opportunities.

Before joining private practice in 1997, Martin was with the Canada Revenue Agency for 21 years where, for 12 years, he was a senior member of the International Tax Directorate in Ottawa. He was integrally involved in developing legislation, policy and procedures, providing technical support to the Department of Justice with respect to litigation in transfer pricing cases, and negotiating APAs.

## Overview

Canada was one of the first countries to implement an APA Programme. The APA Programme in Canada, delivered by the Competent Authority Services Division (CASD) of the International and Large Business Directorate (ILBD), is a proactive service offered by the Canada Revenue Agency (CRA) to assist taxpayers in resolving transfer pricing disputes that may arise in future tax years.

An APA in Canada is an arrangement between the Minister of National Revenue and a taxpayer, which covers certain transactions and arrangements between the taxpayer and non-resident entities. It provides a co-operative process for resolving transfer pricing issues prospectively. APAs benefit both taxpayers and the Canada Customs and Revenue Agency (CCRA) with long-term time savings, efficient resolution of recurring complex matters, greater certainty about transfer pricing issues, potential application of findings to past years and minimising global risks. The APA Programme and the audit programs of the CCRA are separate and distinct.

## Legislation

The CCRA established the APA Programme to help taxpayers determine appropriate transfer pricing methodologies (TPMs) for transactions or arrangements they participate in with non-resident persons. In this regard, IC 94-4R dated 16 March 2001, outlines the procedures and guidelines for obtaining APAs in Canada and provides comprehensive guidance on APAs. Furthermore, on March 18, 2005, the CRA released IC 94-4RSR (Special Release) on the topic of APAs for small business<sup>3</sup>.

## Scope of APA

Any taxpayer may apply for APA consideration, regardless of the size of the organisation, type or scope of its

operations, or the nature of the transactions and proposed TPMs. The taxpayer may select the transactions for which it opts to enter into an APA. The scope and complexity of a case and not the size of a company, as well as other factors (such as the extent of cooperation and quality of information) will determine the time needed to process an APA request.

The term of an APA is usually three to five years, but that may vary depending on the facts, circumstances and resolution of the particular case. At the conclusion of the procedure there is a 'binding agreement' between the taxpayer and the CRA and, in the case of bilateral or multilateral APAs, between the CRA and the other tax authorities involved.

APAs can be unilateral, bilateral or multilateral. However, the authorities prefer to enter into a BAPA or MAPA. If the taxpayer requests a unilateral APA, the taxpayer is required to state why it is not requesting a BAPA or MAPA, if the proposed transactions involve countries with which Canada has income tax treaties. Furthermore, the APA process does not limit the CCRA from notifying a treaty partner in accordance with the relevant treaty that it has accepted a unilateral APA request.

The CRA may also consider issues similar or related to transfer pricing, such as the correct attribution of income between a PE and other parts of the same entity for undertaking an APA.

## Year of Implementation

The APA Programme in Canada, although started officially in 1991, was formally started in 1994. In 1990-91, Canada saw its first APA filing. From 1990 to 1992, two APAs were accepted by the CRA on a trial basis. Following a positive evaluation of the pilot project and continued taxpayer interest, the Programme was formally launched in July 1993.

<sup>3</sup> Defined as the taxpayer having, in the most recent taxation year prior to the request, gross revenues of less than CAD 50 million or, if above that threshold, proposes that the APA cover a transaction in a taxation year of less (or expected to be less) than CAD10 million.

Since then, except for a few years, APA filings have increased. The maximum APA filings took place in 2007-08 with the number of pre-filing meetings surging to 38 as compared to 25 in the previous year – a rise of nearly 50% .

## Administrative Practices

### APA Process

Before commencing the APA process, the taxpayer decides whether the APA is an appropriate approach under the taxpayer’s facts and circumstances. This is the preliminary phase. Once the decision has been taken, the APA process is divided into the following phases:



Figure 10 Overview of the APA Process  
The APA process is designed to produce an APA specifying the:

- Taxpayer and the non-resident entities
- Nature and scope of transactions to be covered

- Appropriate TPMs to be employed
- Period for which an APA is to be effective
- Other terms and conditions

### *Pre-filing meeting (s)*

The pre-filing meeting(s) between the taxpayer and the CCRA officials explores the suitability of an APA, and to informally discuss the APA process and the matters set out in the information circular No. 94-4R dated 16 March 2001. These meetings may also be conducted on an anonymous basis and provide an opportunity to discuss upfront the process, nature and scope of transaction to be covered under the APA, data and documents likely to be needed for the APA submission etc.

### *Processing an APA request*

The CCRA considers the APA request made by the taxpayer for an APA and confirms its commitment to accept a request for a BAPA, MAPA, or unilateral APA by sending the taxpayer an acceptance letter. In the case the APA request is rejected, the taxpayer is given the opportunity to make further representations. There is a cost involved for the filing of each APA which is outlined in an APA acceptance letter issued by CCRA. For a small business APA, a fixed administrative fee of CAD 5,000 is charged by the CRA.

### *Content of an APA submission*

The APA submission must include detailed information about the taxpayer and about the non-resident entities involved in the proposed APA. All information and reasons needed to establish the appropriateness of the proposed TPM must be contained in the submission. Information must contain the effect of the proposed TPM on the covered transactions by applying it consistently to the previous three years, or the most recent business cycle if appropriate. If the taxpayer considers the previous three-year period inappropriate for any reason, it may choose another time period with an

explanation to that effect.

The taxpayer is also required to present a set of critical assumptions under which a proposed TPM would operate. The taxpayer should establish and describe the critical assumptions in detail in its APA submission. The taxpayer should also propose an initial term for an APA, giving appropriate consideration to the industry and transactions involved.

#### *Case work and resolution*

The APA submission is reviewed by the CCRA officials. The team of the officials may conduct site visits to gain a better understanding of the business of the taxpayer and the related industry, to clarify issues and matters in the APA submission with appropriate personnel, and to gather more information. Furthermore, if possible, an interim joint meeting involving all participants in the APA process may also be undertaken.

After the review, analysis and evaluation stage, the position of the APA team is discussed and agreed with the taxpayer. In the case of a unilateral APA request, once the terms and conditions have been confirmed with the taxpayer, the CCRA officials will conclude the APA.

For BAPA or MAPA, neither the taxpayer nor the related entity is involved in the negotiations with the Competent Authority (CA). However, the taxpayer/non-residents may be asked to be present to respond to any questions the Competent Authorities may have during negotiation sessions.

Once the CA negotiations have been successfully concluded, and the terms and conditions have been confirmed with the taxpayer and its related party, CCRA officials conclude the BAPA with the other CA, after which the APA is constituted with the taxpayer.

#### *Competent Authority consideration*

When the Canadian CA agrees to pursue a BAPA or MAPA with the CA of one or more treaty partners, there will be a mutual

exchange of information with those treaty partners concerning all aspects of the APA process, including any subsequent revisions, cancellations, revocations, or requests for APA renewal, in accordance with the relevant tax treaties. In case the negotiations are not acceptable, the taxpayer may reject and withdraw the APA request.

If the CAs cannot reach a BAPA/MAPA, the Canadian CA may provide a unilateral APA. The taxpayer in this case still retains the right to pursue a MAP. However, if double taxation occurs on the transactions covered by the taxpayer's unilateral APA, the Canadian CA may, under the MAP article of the relevant tax treaty, deviate from the terms and conditions in the taxpayer's unilateral APA to resolve the matter with the relevant treaty partner.

#### *Administering an APA*

##### a. APA Reporting

The taxpayer is required to file the APA reports according to the terms of the APA. An APA report will describe the actual operations of the taxpayer for the period and demonstrate the compliance with the terms and conditions of the APA. The CCRA officials would review the APA report, evaluate the results of the agreed TPM in the APA report and whether any adjustments need to be made to the reported results.

##### b. Compensating Adjustments

An APA may include a provision to permit the taxpayer and its related party to make a compensating adjustment. A compensating adjustment would bring recorded amounts or results of the covered transactions into agreement with the amounts or results of the covered transactions as determined by the application of the TPM set out in the APA.

An APA may also provide that compensating adjustments be made throughout the taxation year to ensure that the relevant amounts of the covered

transactions conform as closely as possible to the final amounts of the covered transactions that would be arrived at by applying the TPM agreed to under the APA. These interim compensating adjustments should minimise the amount of the compensating adjustment that may be required at or after year-end.

##### c. Auditing an APA

The Tax authorities may audit the APAs as part of the regular audit cycle. However, under the scope of the audit, the tax authorities will not re-evaluate the TPMs or other terms and conditions agreed to in an APA. The audit of the APA will be limited to establishing the compliance with the terms and conditions of the APA and whether:

- material representations in the APA request, the related submissions, and the periodic APA reports remain valid and accurately describe the taxpayer's operations and those of non-resident entities
- the taxpayer applied the agreed upon TPMs consistently in accordance with the terms and conditions of the APA
- supporting data and calculations used in applying the agreed upon TPMs were correct in all material respects
- critical assumptions underlying the APA remain valid and relevant.

The tax authorities may propose adjustments in the case it is felt that the taxpayer has not abided by the APA. However, such adjustment does not affect the continuing validity of the APA.

##### d. Provision for Roll-Back

The taxpayer may ask, or the tax authorities may decide, to apply the terms and conditions of an APA retroactively to non-statute-barred taxation years. The International Tax Directorate (ITD) will discuss the issue of retroactive application with the taxpayer, the responsible tax official and the non-resident entities' tax administrations, if appropriate, as soon as

possible during the process.

However, the roll-back of the APA is permitted only when the facts and circumstances of the open prior years were similar to those in which the APA was concluded. A request to retroactively apply the terms and conditions of an APA is separate and distinct from an APA request.

#### e. Resolving Disputes

In the case the tax authorities determine that terms of the APA have not been complied with or if the taxpayer does not agree with the proposed adjustments, the issue is submitted to the Director General, who may decide to revise the APA with the taxpayer's concurrence. The decision of the Director General is not appealable and filing of a tax return inconsistent of the Director General's interpretation may result in the APA being either cancelled or revoked. In such a case, the taxpayer may challenge the adjustments through the usual appeal process as if the APA had never existed.

#### f. Revising/revoking/cancelling APA

The APA may be revised in the case it is established that:

- there has been a failure to meet a critical assumption;
- there has been a change in law, including a treaty provision, that modifies the Canadian federal income tax treatment of any matter covered in the APA;
- there has been a material change in circumstances; or
- the participating foreign tax administration's APA is not consistent with the taxpayer's APA or has been revised, cancelled, or revoked.

In cases where the tax payer or the non-resident entities made any material misrepresentation, mistake, or omission in the APA request, APA submission etc, the CCRA may cancel/revoke the APA. In such

a scenario, a written statement specifying the grounds for the cancellation/revocation is provided to the taxpayer and the relevant treaty partners are informed.

#### g. Renewing APA

Executed APAs can be renewed under similar terms and conditions on request, when both the taxpayer and the CCRA are satisfied that the TPMs in the previous APA continue to be appropriate and that there have been no material changes in the facts. In case where material changes have occurred in the facts, circumstances, or critical assumptions underlying the APA, updated studies, analyses, and supporting documentation have to accompany the request to renew the APA.

## Country Chapter

# China



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Spencer is the founder and leader of PricewaterhouseCoopers Transfer Pricing practice for Greater China. Prior to joining the firm, Spencer worked at the Hong Kong Inland Revenue Department. He has 20 years of experience in tax and transfer pricing consulting.

Spencer has been involved in numerous transfer pricing projects, including transfer pricing risk assessment reviews and documentation preparation, audit defense and regional and global tax planning. Spencer has been involved in many significant transfer pricing dispute resolution engagements including the first successful China-Korea bilateral APA (“BAPA”) and China-Europe BAPA as well as the ongoing China-Singapore BAPA and China-US BAPA projects.

## Overview

Under China's new tax and transfer pricing regime, (effective from 1 January, 2010) the APA process has become more formalised and received significant support from China's State Administration of Taxation (SAT) and with the release of significant new regulations through Circular Guoshuifa [2009] No. 2 as well as China's first annual APA report released in 2010.

APAs can be concluded on a unilateral, bilateral or multilateral basis in China. Anecdotal evidence shows that the first formal APA in China was concluded in 1998 between a Chinese taxpayer and a local tax authority. As of the end of 2010, China had concluded close to 20 bilateral APAs with Japan, the United States, Korea and Denmark.

## China's APA Legislation

China uses a three-tiered legislation system comprising:

- Laws, which are enacted by the National People's Congress and its Standing Committee;
- Detailed implementation regulations, which are issued by the State Council and provide elaborations on the laws; and
- Departmental rules and circulars, including Guoshuifa circulars issued by the SAT, which provide further guidance on the application of the laws and detailed implementation rules.

Currently, China's APA legislation includes:

- Article 42 of the Corporate Income Tax Law of the People Republic of China (the CIT Law);
- Article 113 of the Implementation Regulations of the Corporate Income Tax Law of the People's Republic of China (the Implementation Regulations of the CIT Law);
- Article 53 of the Implementation

Regulations of the Administration of Tax Collection Law of the People's Republic of China (the Implementation Regulations of the Tax Administration Law);

- Articles 46-63 of Circular Guoshuifa [2009] No. 2 "Implementation Measures of Special Tax Adjustments (Trial Version)" (Circular 2); and
- The relevant clauses in the agreements for the avoidance of double taxation (the Tax Treaty).

## Criteria for APA Applications

In general, APAs apply to the taxpayers meeting all of the following three criteria as set out in Circular 2:

1. The taxpayer's annual related party transactions exceed RMB 40 million in value.  
Circular 2 provides further guidance on related party transaction types and the criteria for defining related party relationships.
2. The taxpayer complies with China's related party disclosure requirements. According to the relevant regulations, taxpayers shall submit the 'Annual Reporting Forms for Related Party Dealings of Enterprises' with the annual Corporate Income Tax (CIT) return to the tax authority within five months of the end of each year.
3. The taxpayer prepares, maintains and provides contemporaneous documentation in accordance with the requirements of Circular 2.  
Circular 2 provides detailed requirements regarding contemporaneous documentation which should be prepared and maintained by non-exempt taxpayers to document intercompany transactions, and should include organisational structure, business operations, related party transactions, comparability analysis and selection and application of TPM.



## APA Process

Based on the requirements of Circular 2, the conclusion and implementation process for an APA includes six stages:

1. Pre-filing meeting;
2. Formal application;
3. Examination and evaluation;
4. Negotiation;
5. Signing; and
6. Execution and monitoring.

### Pre-filing meeting

Prior to formal application for an APA, the taxpayer is required to submit a written request for negotiation and signing of an APA. Upon receiving the request, tax authorities may conduct a pre-filing meeting with the taxpayer to discuss relevant matters and the feasibility of reaching an APA, and prepare an 'Advance Pricing Arrangement Meeting Record'. During the pre-filing stage, the taxpayer is required to prepare a Letter of Intent regarding the APA application which includes the following contents for discussion with the tax authorities:

- Years to be covered under the arrangement;
- Related parties involved and related party transactions to be covered under the arrangement;
- Overview of the enterprise's business operations in prior years;
- Functional and risk profile of related parties involved in the APA application;
- Whether the methodology in the arrangement would be applied to resolve transfer pricing issues in prior years; and
- Any other situations requiring explanation.

The pre-filing meeting may be held anonymously.

If the two parties can reach an agreement at the pre-filing meeting, the tax authorities should inform the taxpayer in writing within 15 days of

an agreement to commence formal negotiation of matters relating to the APA, and issue the 'Notice of Formal Meeting of the Advance Pricing Arrangement' to the taxpayers.

### Formal Application

The taxpayer should then submit a 'Formal Application Letter of Advanced Pricing Arrangement' and an 'Application of Launching Mutual Agreement Procedures' (in the case of a bilateral APA) to the tax authorities within three months of their receiving the official notice. The contents of the formal application package should include the following:

- Descriptions of relevant group structure, internal organisational structure of the enterprise, related party relationships, and related party transactions;
- Financial and accounting reports of the enterprise for the most recent three years, and information on product performance and assets (including intangible and tangible assets);
- Types of related party transactions and tax years to be covered under the APA;
- Allocation of functions and risks among related parties, including the allocation bases used, such as entities involved, personnel, expenses, assets, etc.;
- Proposed TPM and calculation method in the APA, and the functional and risk analysis, comparability analysis and assumptions used for supporting such methodology and method;
- Market conditions, including industry development trends and the competitive environment;
- Annual information on business scale, business result forecasts and business plans for the period covered under the APA;
- Information regarding relevant related party transactions, business arrangements and financial results

such as profit levels, etc., involved in the arrangement;

- Whether there are double taxation issues; and
- Relevant issues in relation to domestic and international laws and tax treaties.

### Examination and Evaluation

The tax authorities should conduct the examination and evaluation within five months of receiving the formal written application and the relevant documents and information required for the APA from the taxpayer. The tax authorities may request additional information and conduct field reviews during this phase.

The scope of the evaluation conducted by the tax authorities mainly includes the following:

- Review of historical operations;
- Functional and risk profile;
- Comparable companies information;
- Factors influencing profitability in the industry and the enterprise;
- TPM and calculation method; and
- Expected arm's length price or profit range.

### Negotiations

For a unilateral APA, tax authorities should arrange negotiations and discussions with the taxpayer within 30 days of reaching the conclusion of examination and evaluation. Once the tax authorities and the taxpayer reach an agreement through negotiation, the tax authorities will submit the draft APA as well as the evaluation and examination conclusions to the SAT for review and approval.

For bilateral or multilateral APAs, the SAT will arrange negotiations and discussions with the relevant Competent Authorities of the other treaty countries once the SAT has completed its evaluation of the APA application.

### Signing of the APA

The tax authorities and the taxpayer will officially sign the unilateral APA upon reaching an agreement on the contents of the draft unilateral APA.

For bilateral or multilateral APAs, the SAT and the competent tax authorities of the foreign jurisdiction(s) involved will sign the APA. The local tax authorities will sign the 'Bilateral (Multilateral) Advance Pricing Arrangement Implementation Agreement' with the taxpayer in accordance with the bilateral or multilateral APA concluded by the SAT and the other Competent Authorities.

### Execution and monitoring

The taxpayer is required to maintain a complete record of relevant documents and information, (including accounting and other relevant records). The taxpayer is also required to file an annual compliance report in relation to the implementation of the APA to the tax authority within five months of the end of each year.

The annual compliance report should document the business operations and the taxpayer's compliance with the provisions in the APA during the reported period, including all matters required in the APA and state whether there is a need to amend or to effectively terminate the arrangement. The taxpayer must also specify in the annual compliance report any unsettled issues or contingencies, in order to facilitate negotiations and discussions with tax authorities on whether the APA should be amended or terminated.

During the term of the APA, tax authorities will regularly (normally semi-annually) monitor the APA implementation. If the taxpayer's actual operating results fall outside of the expected range of prices or profits under the APA, tax authorities are required, upon obtaining approval from tax authorities at the next higher level, to

adjust the actual operating results to be within the range of prices or profits under the arrangement. In the case of bilateral or multilateral APAs, the adjustment must be submitted to, and approved by, the SAT.

If there are substantial changes that have affected the implementation of the APA, the taxpayer must report these changes to tax authorities in writing within 30 days, with detailed explanations. Based on the review of the taxpayer's operations, the tax authority will discuss with the taxpayer to revise the provisions and relevant conditions of the arrangement, or take reasonable measures to amend or even terminate the arrangement depending on the impact of the changes on the implementation of the APA.

### Roll-back

According to Article 49 of Circular 2, negotiation and signing of the APA does not affect the transfer pricing investigations or adjustments conducted by tax authorities on the enterprise's related party transactions in the year during which the enterprise submits its formal written application or any prior years. On the other hand, if the related party transactions in the year of application or any prior year are identical or similar to those covered in the APA, the in-charge tax authorities may allow the TPM and calculation method(s) specified in the APA to be applied to the evaluation and adjustment of the prior year related party transactions based on the taxpayer's application.

### Renewal

An APA becomes invalid automatically once it expires. Requests for renewal should be filed with the tax authorities 90 days prior to the expiration of the APA. The taxpayer should submit an 'Advance Pricing Arrangement Renewal Application' along with supporting evidence to confirm that there have not been any substantial

changes to the facts and conditions in the existing APA and that the taxpayer has been in full compliance with the provisions and requirements of the APA. After receiving the application, tax authorities will review and evaluate the application documents, and negotiate with the enterprise to draft the new APA.

### Time Frame for Negotiating an APA

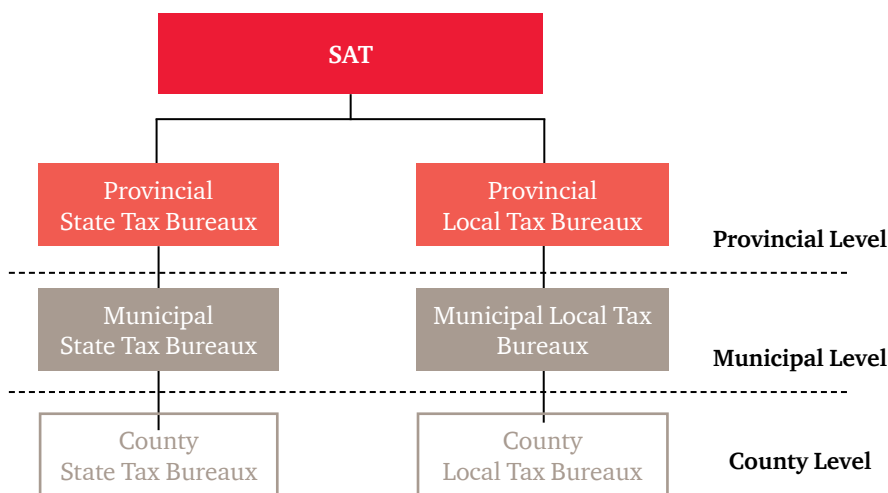
The Chinese tax authorities generally aim to complete the review and negotiation process within 12 months for unilateral APAs and within 24 months for bilateral APAs. However, in practice the time required to complete the APA process depends on many factors such as the complexity of issues involved, the type of APA, and the taxpayer's cooperation. Statistics released by the SAT covering the years 2005 through 2009 showed that the SAT was able to meet the 12 month goal for unilateral APAs 56% of the time and to meet the 24 month goal for bilateral APAs 83% of the time. In addition, 58% of bilateral APAs were completed in less than 12 months.

## China's APA Features and Latest Developments

In general, the Chinese APA Programme is consistent with the regulations and practices in many other countries. However, it also reflects certain unique features of China's tax regime.

### APA applications involving multiple levels of tax authorities

The following illustration depicts the hierarchy of the tax collection and administration system in China:



The SAT is the highest tax authority in China, and assumes vertical leadership over the various levels of state tax authorities and assists the local governments in a form of dual leadership over the local tax authorities. The county-level or municipal-level state tax bureaus are usually the local tax authorities responsible for CIT collection and administration. Therefore, in applying for an APA the taxpayer has to deal with multiple levels of state tax authorities from the county-level tax authorities up to the SAT, especially in the case of bilateral APAs. Depending on the nature of the transactions and the tax implications, taxpayers might need to

submit APA applications to both state tax authorities and local tax authorities (for example, where the taxpayer would like its APA application to cover CIT and local taxes such as Chinese Business Tax).

Since group consolidation of income for tax purposes is generally not allowed in China, different legal entities within the same multinational group must file separate income tax returns. For the same reason, these entities must submit separate application to their respective tax authorities when applying for APAs. To

cover intercompany transactions between a foreign parent company and its multiple Chinese subsidiaries in a bilateral APA, each of the Chinese subsidiaries needs to submit a separate bilateral APA application to its in-charge tax authority, even though the foreign parent company needs to file only one application in its resident country.

To streamline the procedure, Circular 2 provides that for APAs involving two or more provinces, autonomous regions, or municipalities, or involving both the state and local tax authorities, the SAT will organise and coordinate the process. In addition, the taxpayer can directly submit a Letter of Intent to the SAT.

### Tax authorities' focus points during APA examination and negotiation

Based on our recent observations, the Chinese tax authorities (including the SAT) usually focus on the following matters during APA examination and negotiation:

- Functional analysis and value chain scrutiny;
- Location/cost savings;<sup>5</sup>
- Marketing intangibles; and
- Profit split method as a possible transfer pricing evaluation method.

### Release of the APA report

On 30 December, 2010 China joined Korea, Japan, the United States, Canada, Australia and Italy as one of the first countries to issue a comprehensive report regarding its APA Programme. The groundbreaking report provided official statistics on both in-progress and completed APAs for the period from 1 January 2005 to 31 December 2009, and reaffirmed the SAT's focus on transfer pricing issues and in particular its commitment to the APA Programme.

Several key trends were highlighted by the report and the statistics it contained, including:

- The rise in the number of signed bilateral APAs, which overtook the number of unilateral APAs for the first time in 2009;
- The rise in the number of applications related to intangible assets or services which now exceed the number of applications related to tangible goods transactions;
- The fast processing time for unilateral and bilateral APAs; and
- The popularity of the transactional net margin method (TNMM), which was used in 60% of signed APAs.

The report and the statistics it contained are a clear indication of the SAT's support

<sup>5</sup> As discussed during a 2009 recent interview with one of the SAT's tax officials, the Chinese tax authorities are considering whether the financial benefits arising from lower operating costs in China as a result of cheaper land and lower labour costs when compared to other countries globally belong to the China affiliate in a related party situation rather than an offshore parent or affiliate. See Chinese Official Discusses Advance Pricing Arrangement Program, Tax Management Transfer Pricing Report, 18 TPR 247, 07/23/2009, the Bureau of National Affairs

of the APA Programme. However, there is a concern on whether the Programme's limited resources can keep up with taxpayers' growing interest in APAs, especially at the SAT level where additional economists and other technical staff are needed to prevent delays in APA applications. We have noticed that the SAT has become more selective in accepting applications, in part due to a strategy of using APAs to set precedents for transfer pricing nationwide, and in part due to the increasing technical sophistication of the tax officials, who are now more discerning in deciding whether or not to accept APA applications. While the APA Programme has clearly been a success so far, the process in China is still by no means straightforward and taxpayers should ensure that they are adequately prepared before entering into APA negotiations.

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*Country Chapter*

*Japan*



***Toyoharu Nakamura***

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Toyoharu Nakamura had worked for 30 years for National Tax Agency, then joined PwC in 2005, and has been working as a partner. At NTA he mainly engaged in Competent Authority negotiations, he was also actively involved in OECD-CFA work programs, and made significant contributions to the revision of the 1995 OECD transfer pricing guidelines. His expertise in the transfer pricing area is especially noticeable in the field of Audit defense, APA and Competent Authority negotiations.

## Overview

Japan was the first country in the world to introduce APA procedures when it introduced its APA Programme in 1987 shortly after the introduction of formal transfer pricing legislation in 1986. Although few APAs were concluded in the years immediately following the introduction of the programme in 1987, as other countries introduced their own formal APA programs in the early to mid 1990's, the number of APAs requests filed in Japan began to rise. The number of APAs requested in Japan continues to increase as global enforcement of transfer pricing practices becomes more prevalent.

Like most APA programs, Japan's APA Programme allows taxpayers to formally request approval of prospective transfer prices on either a unilateral, bilateral, or multilateral basis. Approvals are provided by Japan's National Tax Agency (NTA) after the request is reviewed locally by the Regional Taxation Bureau (RTB) having jurisdiction over the requestor's tax return. In the context of a BAPA, or multilateral APA, an approval is provided by the NTA after an agreement is reached with foreign tax authorities under the authority of MAP.<sup>6</sup>

The NTA promotes BAPAs to facilitate the enforcement of transfer pricing regulations, mitigate the administrative burden on corporations, ensure tax predictability, and to reduce the risk of double taxation. As a result, the vast majority of APAs requested in Japan have been made on a bilateral basis, and the number of BAPA requests continues to increase. Since 1997, the number of BAPA requests has increased by a factor of approximately five, with the NTA receiving 113 new BAPA requests in 2007.<sup>7</sup> Through June 30, 2007, nearly 600 BAPA requests had been filed, and over 400 BAPA or multilateral requests had been completed.<sup>8</sup>

Given the increase in the number of APA requests in Japan, the NTA continues to

increase the number of examiners processing APA requests and staff supporting the Programme. In 2007, the NTA added an additional director to the APA Programme, and established two new APA sections within its MAP office.<sup>9</sup> The NTA also established in 2007, an APA division within the Osaka Regional Taxation Bureau, in addition to the existing one in Tokyo RTB.<sup>10</sup> With the continued increase in the number of people supporting the APA system, and given the overall efficacy of the programme historically, the APA system continues to be an effective means through which Japanese taxpayers can manage transfer pricing risks

## Legislation/Administrative Guidelines

While transfer pricing enforcement is governed by Special Taxation Measures Law, Article 66-4, Article 68-88, and STML Enforcement Orders (Articles 39-12, 39-112, and 22-10), guidelines regarding the APA system and MAP procedures have been issued through subsidiary administrative circulars. Specifically, the NTA originally issued explicit guidance on APA procedures in the *Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines)* in 1999 despite the introduction of the programme in 1987. These guidelines were carried over into the succeeding *Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines)* issued on June 1, 2001, which have gone through successive updates, the latest being made in October 2008 (the Transfer Pricing Administrative Guidelines). Guidance on MAP procedures are included in the *Commissioner's Directive on Mutual Agreement Procedures (Administrative Guidelines)* issued on June 25, 2001 (the MAP Guidelines).

<sup>6</sup> Ibid.

<sup>7</sup> National Tax Agency Report 2009

<sup>8</sup> PricewaterhouseCoopers, *International Transfer Pricing 2009*, p. 498.

<sup>9</sup> National Tax Agency APA Program Report 2008, p. 5.

<sup>10</sup> Ibid.

## Administrative Practices

### Procedure for Filing an APA Request

Based on guidance provided in the Transfer Pricing Administrative Guidelines, a taxpayer submits its APA request to the District Director (RTB Commissioner) who has jurisdiction over the company's tax return. The applicant will file a form, entitled 'Request for APA of the TPM'<sup>11</sup> with the RTB Commissioner. The request and form is supplemented by a document prepared by the taxpayer containing the details of the selected TPM (APA Report or BAPA Report), including (i) a description of the transactions to be covered by the APA and the entities engaging in the transactions; (ii) the proposed term; (iii) a functional analysis of the entities engaging the controlled transactions subject to the APA; (iv) a description of the proposed TPM and why it is considered to be the most reasonable TPM; (v) the analysis, information and data used to determine the TPM; and (vi) other relevant information or documents.<sup>12</sup> APA requests must be prepared in writing in Japanese, although some supplemental documents may be provided in English. The APA requests are filed in duplicate to the District Director and there is no fee required.

The filing due date of APA requests changed with the most recent update to the Transfer Pricing Administrative Guidelines in October 2008. APA requests are now required to be made prior to the day before the first day of the first taxable year to be covered in the request. As this deadline was recently introduced, certain transitional filing dates are allowable for companies that wish to include tax years beginning November 1, 2008 through October 31, 2009 as the first taxable year to be covered in the APA request. For companies with tax years beginning within this time frame, APA requests are required to be filed within eight months of the due date of the final tax return for the

tax year immediately preceding the first taxable year to be covered in the APA request.

The NTA encourages corporations to file APA requests on a bilateral basis. Requests for MAP consideration are made simultaneously with the submission of the BAPA request and a separate copy of the BAPA request, including relevant supporting documents (i.e., the BAPA Report), is provided to the NTA along with a formal request for MAP consideration.<sup>13</sup>

### Pre-filing Consultations<sup>14</sup>

Companies contemplating an APA may request a pre-filing consultation with representatives from the RTB division having jurisdiction over the place of the corporation's tax payment and, in cases involving a BAPA request, representatives from the NTA's MAP office. Pre-filing consultations are intended to facilitate the APA application process. Matters discussed during a pre-file consultation may, in general, include: (i) an overview of the transactions and entities to be covered under the contemplated APA; (ii) the underlying facts to the transaction, including high-level functional overviews and other relevant facts; (iii) the contemplated TPM; and (iv) the expected term of the APA, including the inclusion of prior years through a retrospective application (roll-back) of the agreed upon TPM.<sup>15</sup> The RTB and NTA representatives will typically provide high-level comments regarding the proposed APA, and will also, typically, provide guidance to the taxpayer with respect to matters that may assist in their review of the APA request.

### Timeline for Reviewing and Negotiating APAs and BAPAs

The review and confirmation of APA requests by the RTB and NTA may vary depending on a number of factors. Specifically, the timing of APA reviews and negotiations may depend on (i) whether or not the request is made on a unilateral or

bilateral basis; (ii) the complexity of the transaction to be covered; (iii) the availability of RTB examiners to review the application; and, in cases involving BAPAs, (iv) the time taken by treaty partners to review the BAPA request.

BAPA reviews are first initiated by reviewers from the APA division of the RTB that is segregated from jurisdictions over the company's tax return filings. This review has historically taken approximately one year to complete, although, as noted below, a recent mandate made by the NTA has shortened this time frame. After the completion of the RTB review, the RTB provides an opinion consisting of a summary of their analysis and findings to the NTA MAP office (the RTB Opinion). The NTA then uses the RTB Opinion to establish an initial negotiating position for use in discussions with the Competent Authority of the treaty partner involved in the BAPA request. In most cases, the time required to finalise a BAPA request has been approximately two to three years.<sup>16</sup>

Significant emphasis has been made by the NTA in recent months to expedite the RTB review process. In many recent cases, RTB examiners have initiated the review of APA requests almost immediately after the submission of the APA request has been received. Companies requesting APAs should expect to receive a request for a meeting and initial questions from the RTBs sometime during the second month after the submission of the APA request. Depending on the complexity of the transactions that are the subject of the APA request, RTBs may now provide RTB Opinions to the NTA MAP office within six months of the filing of the APA request.

Given the expedited review of BAPA requests by the RTBs, the actual completion of a BAPA request will now most likely depend on the timing of the review undertaken by APA reviewers and MAP officers in the foreign countries

<sup>11</sup> TPM refers to "Transfer Pricing Method"

<sup>12</sup> Transfer Pricing Administrative Guidelines Section 5-3

<sup>13</sup> MAP Guidelines Section 6(1)(f) and Section 9

<sup>14</sup> Transfer Pricing Administrative Guidelines Section 5-10

<sup>15</sup> APA terms are in principle confirmed for three to five years per Transfer Pricing Administrative Guidelines Section 5-7. Roll-backs will be considered pursuant to considerations made under Transfer Pricing Administrative Guidelines Section 5-23.

<sup>16</sup> Unilateral APA requests are approved by the NTA shortly after RTB review, and therefore, have historically taken approximately one year to complete. The new mandate to expedite RTB reviews may shorten this time frame.

involved in the BAPA request. The timing of finalising a BAPA request could also be influenced by the frequency in which the relevant Competent Authorities meet to discuss a particular case. As a result, while taxpayers may expect to complete the RTB review of its BAPA request within six months of filing the request, the foreign country review of the request and subsequent MAP negotiations may delay the actual timing when the agreement is finalised.

### Roll-Back Provisions

Section 5-23 of the Transfer Pricing Administrative Guidelines allow consideration for applying the agreed upon TPM for years prior to the years agreed upon in the APA. For the confirmed TPM to be applied to prior years, the roll-back request should be included in both the original APA request and the request for MAP consideration. In addition, it is necessary to demonstrate that the proposed TPM be also regarded as the most reasonable TPM for the years prior to the years confirmed under the APA.

However, in practice, as economic conditions, etc. in the past years are usually different from those of the APA years, the NTA has often reached agreements at a dollar amounts base instead of simply retroactively applying the Agreed APA method.

## Post-Agreement Documentation/Administration

### APA Annual Reports

Corporations that have confirmed APAs are required to submit reports demonstrating compliance with the terms of the APA on an annual basis (APA Annual Reports). The APA Annual Reports are required to be filed no later than the prescribed tax return filing due date of the confirmed corporation. APA Annual Reports are filed in duplicate, and should contain the following information:

1. A statement that the confirmed corporation filed its tax returns in compliance with the terms of the APA;
2. Profit and loss statements of the confirmed corporation and applicable foreign related party or parties involved in the confirmed transaction;
3. A statement of material changes in business or economic conditions;
4. A statement of any adjustments made to comply with the APA terms;
5. Financial and accounting data for the confirmed corporation and applicable foreign related party for the confirmed tax years; and
6. Other relevant information needed to demonstrate that the confirmed corporation's tax returns comply with the terms of the APA.

The APA Annual Report is submitted to the APA division in RTB, responsible for APA matters for review. During their review, the RTB may request additional information to clarify information contained in the APA Annual Report. After review, the RTB division forwards the results of its review to the MAP office through the NTA division responsible for the MAP agreement.<sup>18</sup>

### Compensating Adjustments (Price Adjustments)

Compensating adjustments made to comply with the terms of the APA are regarded as legitimate transactions for the purpose of transfer pricing enforcement.<sup>19</sup> In instances where price adjustments are required, adjustments are generally made on the current year tax return. In cases where the tax return has already been filed, the taxpayer is required to file an amended return to reflect the terms of the APA. Requests for correcting prior year tax returns to comply with APA terms in a bilateral context can be made through a request for correction under Article 7(1) of the Act on Special Provision for the Enforcement of Income Tax Conventions.<sup>20</sup>

Secondary adjustments corresponding to the compensating adjustment, and which usually take the form of a cash settlement, do not result in associated tax consequences in Japan since such adjustments are not treated as deemed dividends or deemed capital investments.

## Country Specific Issues/Latest Developments

The NTA annually publishes a report on the APA Programme (the APA Programme Report) that contains recent trends, information on the number of cases concluded and methods used, and the number APA cases in inventory, among other statistics. The 2008 APA Programme Report, which addresses the 2007 fiscal year<sup>21</sup>, provides various statistics regarding the programme. Given that the vast majority of APA requests are made on a bilateral basis, the statistics included in the APA Programme Report focus on BAPA cases. In the 2007 fiscal year, the RTBs and NTA received 113 new BAPA cases, disposed of 82 cases, and had a remaining inventory of 222 cases.

<sup>18</sup> Transfer Pricing Administrative Guidelines Section 5-18(3).

<sup>19</sup> Transfer Pricing Administrative Guidelines Section 5-19(1).

<sup>20</sup> Transfer Pricing Administrative Guidelines Section 5-19(2)(d).

<sup>21</sup> The fiscal year commences July 1 and ends on June 30. The 2008 APA Program Report addresses statistics for the July 1 2007 through June 30 2008 period.

<sup>22</sup> NTA APA Program Report 2008, Attachment 2



## 2005-2007 MAP Statistics

Business Year		BAPA	Transfer Pricing Taxation	Others	Total
2005	Cases Received	92	27	10	129
	Cases Disposed	65	16	12	93
	Cases Carried Over	170	40	27	237
2006	Cases Received	105	35	14	154
	Cases Disposed	84	16	15	115
	Cases Carried Over	191	59	26	276
2007	Cases Received	113	31	9	153
	Cases Disposed	82	33	10	125
	Cases Carried Over	222	57	25	304

In addition to the growth in the number of BAPA requests made by Japanese corporations over the last three years, as shown above, it is interesting to note, that among the cases disposed in the 2007 fiscal year, 50 cases relied on a TNMM-based TPM and that among the number of disposed cases, the majority of the cases, 67, involved tangible property transactions.

As noted in 3.3 above, the NTA has introduced an initiative to process APA requests more quickly. This initiative may be in response to the number of outstanding APA requests, which in the 2007 fiscal year, numbered 222, and the continued increase in requests for APAs from Japanese taxpayers. Current practice indicates this initiative to be effective, with APA reviews being conducted by the RTBs at an accelerated rate.

## Summary

The Japanese APA system continues to be an effective and viable means through which Japanese corporations can obtain certainty on the prices charged in intercompany transactions. The NTA recognises the importance of the programme to taxpayers in Japan and has continued to improve the system by increasing dedicated staff to support the system, and by introducing initiatives to expedite the processing of APA requests.

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**Country Chapter**

**United Kingdom**



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Until early 2009 Diane Hay was the Deputy Director at HM Revenue & Customs with responsibility for international corporate tax issues, including transfer pricing. She was also the UK's Competent Authority with responsibility for the Mutual Agreement and the Advance Pricing Agreement programmes and a member of the OECD's Working Party 6 Bureau and the Committee on Fiscal Affairs

Since May 2009, Diane has been working at PwC on international corporate tax, advising both UK and global clients. She specialises in MAP and APA work and is a member of the Global Controversy and Tax Dispute Network which brings together dispute resolution experts from across PwC.

## Overview

The UK's interest in APAs began over twenty years ago, sparked primarily by the need to find a practical way to apply the arm's length standard to the transfer pricing issues raised by US, UK and Japanese banks operating a 24 hour global trading book. While the UK retains a general threshold of complexity for entry into its APA programme, the programme has broadened considerably to cover a wide range of industrial sectors and transfer pricing issues. The UK normally prefers bilateral APAs, unless there are good reasons why another tax authority cannot be included (for instance, if there is no appropriate tax treaty). In HM Revenue & Customs's (HMRC's) view a unilateral APA can only provide a partial solution of cross-border transfer pricing issues, as it only confirms the tax treatment in the UK and does not eliminate the risk of double taxation. In order to remove any potential double taxation, the UK will generally seek to reach agreement with the other country if there is a bilateral tax treaty in existence which contains a Mutual Agreement procedure.

## Legislation

Sections 85 to 87 of Finance Act 1999 provided the legal framework for the UK's APA regime and this can now be found at Sections 218 – 230 of the Taxation (International and Other Provisions) Act 2010 ('TIOPA 2010'). Further practical guidance was available in a Statement of Practice (SP 3/99) which has now been superseded by Statement of Practice 2/10. The new Statement of Practice is important in signaling a greater relaxation of the UK's position as regards both the need for complexity in order to be accepted within the APA Programme and also the strong preference for bilateral APAs.

In addition, a special APA for thin capitalisation cases, the Advance Thin Capitalisation Agreement (known as an

'ATCA'), was introduced in 2007 which uses the legal framework of the general APA legislation, but which is operated under another Statement of Practice (SP 04/07). (The ATCA is not covered in any more detail in this summary.)

## Scope of APA regulations

The UK's general APA legislation provides for both unilateral and bilateral APAs. The scope is set out in Section 218(2) TIOPA 2010 and most APAs are concerned with:

- Transfer pricing issues between separate enterprises where questions may arise as to the determination of the arm's length provision under the UK's transfer pricing legislation, found in Part 4 TIOPA 2010 (previously Schedule 28AA ICTA 1988)
- The attribution of income to any permanent establishment through which an enterprise is carrying on, or intends to carry on, a trade in the UK.

In addition, while the legislation does not specifically provide for a ruling on the existence of a permanent establishment, APAs can in practice include a determination that the potential income to be allocated to any possible UK permanent establishment is nil.

An APA can be requested by:

- any UK business, including a partnership, to which the transfer pricing provisions in Part 4 TIOPA 2010 apply
- any non-resident trading in the UK through a permanent establishment
- any UK resident trading through a permanent establishment outside the UK.

The scope of an APA is very flexible and can cover any specified transfer pricing issue between related parties, including the transfers of tangible and intangible property and the provision of services.

## Administrative practices

### Procedure for filing an APA request

HMRC's Business International Division is responsible for all APA applications, other than APAs involving oil taxes which are dealt with by the specialist Oil & Gas Sector unit of HMRC's Large Business Service. The APA team is headed by a Programme Manager with delegated Competent Authority status for APA matters.

In considering whether to accept an APA application, under the new SP 2/10, every case is considered on the basis of its own facts and circumstances. HMRC will generally be looking for one or more of the following characteristics:

- transfer pricing issues that are complex rather than straightforward – meaning that there is doubt as to how the arm's length standard might be applied
- A risk profile for the taxpayer that would not be 'low risk' without an APA
- A transfer pricing method that is highly tailored to the taxpayer's own circumstances.

HMRC generally recommends that APAs are bilateral but under SP2/10 expresses a willingness to undertake unilateral APAs where:

- An extension to a bilateral APA would unnecessarily complicate and delay the process
- The other party is resident in a country that does not have an APA programme
- There is little to be gained from a bilateral agreement, for example, where the UK is at the hub of arrangements that involve a number of other countries.

In dealing with an APA application, the Programme Manager is supported by transfer pricing specialists and other tax

specialists with responsibility for the taxpayer's affairs.

The APA process typically comprises 4 stages:

#### 1. Expression of interest

A business interested in an APA may wish to explore and clarify in advance various aspects of a potential application and to discuss informally issues such as the proposed methodology, the likely documentation requirements, what is required and what the company needs to provide. This is frequently done on a 'no-name' basis. In practice we believe that HMRC regards the Expression of Interest as a vital step in the process. HMRC will take the opportunity to ask detailed questions about the application to ensure that it is one that can be accepted for an APA.

#### 2. Formal Submission of Application

There are no standard requirements when making the formal application. HMRC is very flexible on this and takes a pragmatic view of the format and content. In a bilateral case, HMRC will usually agree to the submission of the same material in the same format as required by the other treaty partner.

It is essential, however, that the formal submission sets out the commercial facts and drivers of the business in detail and includes a proposal for establishing an 'arm's length provision' as required by the UK legislation. This will set out the method by which it is proposed to determine the transfer pricing issues in accordance with the arm's length standard that complies with the UK legislation and the OECD Transfer Pricing Guidelines.

Another essential element of the formal submission is the identification of those assumptions made in developing the proposed transfer pricing method which are critical to the reliability of its application under the arm's length

standard. These 'critical assumptions' are important because they protect both the company and HMRC from the risk that the APA may become inappropriate as events happen, but they should at the same time not be so tightly drawn that the certainty provided by the APA is unnecessarily jeopardised.

#### 3. Evaluation

HMRC expect the examination of the application to be a co-operative process in which the transfer pricing issues are discussed as openly as possible and the company willingly provides whatever information or further explanations are required.

In the case of a bilateral APA, HMRC will expect the company to make available the same information and documentation to both treaty partners at the same time. HMRC will in turn keep the company informed of the progress of its discussions with the other treaty partner.

On occasions HMRC and the other treaty partner may meet together with the company to try to reach a shared understanding of the commercial background and the detail of the taxpayer's proposals.

#### 4. Agreement

The APA made between the company and HMRC is a binding undertaking on the treatment of the specified transfer pricing issues for a particular period of time. In the case of a bilateral APA, there will also be an agreement between the two tax authorities under the Mutual Agreement Provision, which will be reflected in the agreement with the company.

The agreement will require a commitment from the company that it will adhere to the transfer pricing method agreed in the APA to be confirmed in an annual compliance report.

In the case of a bilateral APA, there will generally be three agreements – being an

agreement between the taxpayer and each tax administration and a separate agreement between the two competent authorities. While the taxpayer cannot see the competent authority agreement, it is usually possible for the details of the transfer pricing methodology agreed between the two competent authorities (which is its key element) to be described in a separate document which is made available to the taxpayer.

Most APS's are for a period of 5 Years, although shorter or longer periods can be requested. Where an APA has taken an exceptionally long time to negotiate, HMRC is willing to consider extending the term of the APA slightly to provide sufficient future coverage.

#### **Cost involved in filing of an APA application**

There is presently no charge levied by HMRC for entry into the APA programme – and there is no expectation that charges will be introduced in the future.

#### **Time lines for negotiating a Unilateral/Bilateral APA**

Currently, a bilateral APA takes on average between 18 to 21 months to negotiate. Bilateral APAs with certain countries, such as the US and Japan, have tended historically to take longer than this.

Unilateral APAs usually take less time than bilateral ones – sometimes they can be considerably quicker. A lot will depend on the facts of each case and the parties' willingness to move at a fast pace.

#### **Post-agreement documentation**

The UK has no documentation rules as regards APAs. Again it takes a very flexible approach and the documentation needed for the years of the APA will be covered in the closing agreement. This agreement will cover the format and content of the annual compliance reports which should demonstrate adherence to the APA agreement. These reports will, as far as the

covered transactions are concerned, usually substitute for the formal documentation required under the transfer pricing legislation. What this should mean in practice is that, assuming the annual reports show a satisfactory result in line with the expectations of the APA, the UK inspector ought to have no grounds to raise any questions about this area of transfer pricing.

#### **Revising and renewing APAs**

If there is a change in the business, for example one which makes the agreed TPM difficult to apply, but this does not go so far as to trigger a critical assumption, an APA may be revised if the taxpayer and HMRC agree. In the case of a bilateral APA, the other country must also agree to this.

Companies may seek a renewal of their APA either before they formally reach the end of their term or during the first tax year after the end of the APA. Renewals are frequently granted on the basis that the transfer pricing issues under consideration remain the same as does the existing TPM. Slight changes may also be accommodated within a renewal, but changes of a more fundamental nature will require a new APA application.

#### **Cancellations and renegotiations**

If a critical assumption is triggered, then the taxpayer and HMRC will need to examine the implications of this for the continuation of the APA. If this has resulted from major changes in the taxpayer's commercial position, it is usually possible to see if the APA can be left as it is, or changed to reflect the new situation. Alternatively the APA may require to be cancelled.

We understand that cancellations are very rare indeed and even major corporate events such as a take-over of the company subject to an APA have been accommodated.

#### **Provision for roll back**

As APAs can take some time to negotiate, the early years of an APA may already have passed by the time the APA is signed and prior years may still be open for enquiry. There may well therefore be a desire by both the taxpayer and HMRC to 'roll-back' the enquiry to cover these years. The UK is usually very flexible about this, but in the case of a bilateral APA will need the approval of the other competent authority, which may not be easy to obtain in all cases.

On rare occasions, taxpayers have found it possible to resolve difficult issues, such as an open transfer pricing enquiry, through the APA process, whereby an APA is negotiated for the future and used to settle the past through this 'roll-back' mechanism.

#### **5. Latest developments**

We understand that the UK aims to conclude at least 15 APAs a year. At present there are approximately 50 ongoing APAs in place. Around 50% of all APAs are with either the US or Japan, and a large proportion of the rest with major treaty partners such as Australia, Canada, France and Germany. The number of countries that have been involved in bilateral APAs with the UK is however growing significantly. Most EU Member states have now introduced APA programmes or legislation and a number of these, including a number of eastern European countries, are showing interest in bilateral APAs. In addition, the UK has also entered into a small number of 'multilateral' APAs principally within the EU, which are in effect a series of linked bilateral APAs.

#### **6. Key learnings**

The UK's experience with APAs has largely been a very positive one for both HMRC and taxpayers. One of the most important keys to its success has been the highly flexible approach that has been taken in arriving at innovative and bespoke

transfer pricing solutions to difficult issues, in drawing up APA agreements and the requirements for annual reporting, and the non-prescriptive view taken on roll-backs and extensions.

In part the flexibility is due to the absence of firm rules and operating through a Statement of Practice. Having the right people in the APA team is also important. The UK has always staffed its APA team with experienced transfer pricing specialists who have many years of transfer pricing experience. The UK also sees good commercial awareness and negotiation skills as just as, if not more, important attributes than technical expertise or economist training.

For a successful APA, it is vital that all sides remember that they are not in an audit. There needs to be openness and trust between the company and the tax administrations involved and a willingness to share information without the need for formalised requests and procedures.

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*Country Chapter*

*United States*



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Gregory J. Ossi is a Principal at PricewaterhouseCoopers (PwC), working in the Transfer Pricing group of the firm's National Tax Services practice in Washington, D.C. Greg brings to PwC over 27 years of experience, in both private practice and government service, helping to avoid and resolve transfer pricing and other international tax controversies faced by multinational taxpayers.

At PwC, Greg serves as the dispute resolution lead on a variety of national transfer pricing projects and supports global transfer pricing controversy, planning and compliance efforts.

## Overview

The U.S. APA Programme is the largest and one of the most successful in the world. It is designed to resolve the actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed TPM<sup>24</sup> APAs can be unilateral, bilateral, or multilateral.

## Legislation

The APA Programme was established by the IRS to allow the IRS and taxpayers to resolve transfer pricing issues in a principled and cooperative manner.<sup>25</sup> The APA Programme was established and operates under the authority of revenue procedures issued by the IRS. Since 1991 with the issue of Revenue Procedure 91-22, 1991-1 C.B. 526, IRS has offered taxpayers, through the APA Programme, the opportunity to reach an agreement in advance of filing a tax return on the appropriate TPM to be applied to related party transactions.<sup>26</sup> Since then, the IRS has updated and modified the governing APA procedures four times. The APA process is currently governed by Revenue Procedure 2006-9, as amended by Revenue Procedure 2008-31.<sup>27</sup>

## Scope of APA regulations

APA is a voluntary process, and the taxpayer decides which transactions to cover under an APA. There is no strict requirement by IRS that all the related entities and all the product lines among the related parties be covered.

A typical APA request is usually submitted for a minimum term of five years. However

a shorter or longer term may be justified and agreed upon between the IRS and the taxpayer.

Taxpayers can request a unilateral, bilateral, or multilateral APA depending on the facts and circumstances. The policy of the IRS is to encourage or require taxpayers to undertake bilateral or multilateral APAs when a tax treaty exists and Competent Authority procedures may be available for the APA process with respect to the foreign country or countries involved.<sup>28</sup> Nevertheless, the IRS may implement a unilateral APA with a taxpayer without attaining a Competent Authority agreement.

## Year of Implementation

The APA Programme has been a resounding success. It was established by the IRS in 1991.<sup>29</sup> Since its inception, over 1200 APA applications have been filed and over 840 APAs have been executed between taxpayers and the IRS. In 2008, the number of new APA applications surged by 33% and this pace has continued through 2009. A record high 127 APA applications were filed during 2009, following the record breaking year of 2008 in which 123 applications were filed. The APA Programme estimated that the number of APA applications filed in 2010 would continue at the same high rate as in 2008 and 2009.<sup>30</sup>

## Administrative Practices

### APA Process

Before commencing the APA process, the taxpayer decides whether the APA is an appropriate approach under the taxpayer's facts and circumstances. This is the preliminary phase. Once the decision has been taken, the APA process is divided into the following seven phases:

<sup>24</sup> <http://www.irs.gov/businesses/corporations/article/0,,id=96277,00.html>.

<sup>25</sup> <http://www.transferpricing.com/pdf/Rev.%20Proc.%202008-31.pdf>

<sup>26</sup> See "Announcement and Report Concerning Advance Pricing Agreements," (March 29, 2010)

<sup>27</sup> Rev. Proc. 2006-9, 2006-2 I.R.B. 1; Rev. Proc. 2008-31, 2008-23 I.R.B. 1133.

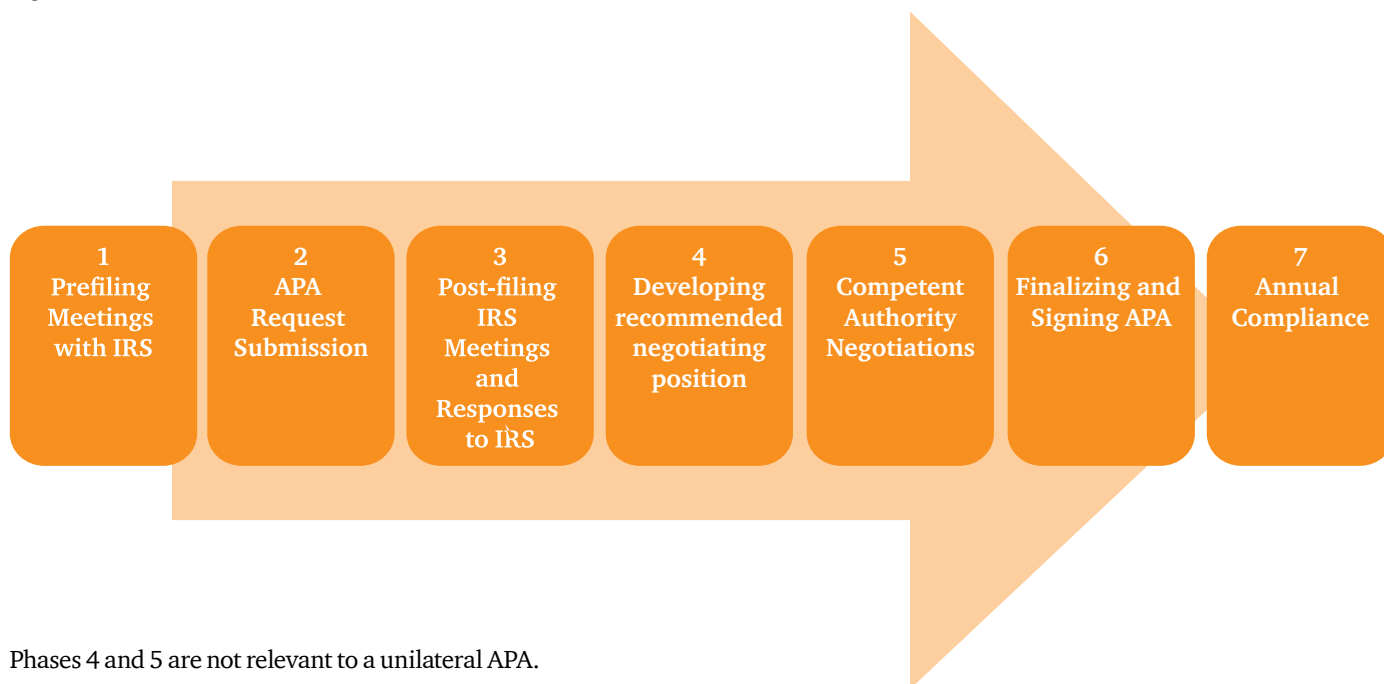
<sup>28</sup> §§ 2.08 and 7 of Rev. Proc. 2006-09

<sup>29</sup> See "Announcement and Report Concerning Advance Pricing Agreements," Announcement 2009-28, (March 27, 2009).

<sup>30</sup> See "Announcement and Report Concerning Advance Pricing Agreements," (March 29, 2010)



Figure 11 Overview of the APA Process



Phases 4 and 5 are not relevant to a unilateral APA.

### Pre-filing meetings with the IRS

The pre-filing meeting provides the taxpayer with a valuable opportunity to obtain feedback from the IRS APA team and to assess the likelihood of reaching an agreement. They can also help to formulate and guide the APA negotiation strategy. Such meetings can generally be scheduled within a month of first contacting the IRS APA office. Pre-filing meetings can be held on a named or anonymous basis.

### Filing the APA request

The taxpayer submits the APA request to the IRS<sup>31</sup>. The APA submission must include a transfer pricing analysis in support of the proposed TPM, a comprehensive description of the taxpayer’s facts and circumstances, a function and risk analysis, a detailed industry and economic analysis, and a proposed TPM. The submission should also provide the IRS with reasons to accept the taxpayer’s position and why the position is fair to the government.

### Cost involved in filing the APA

The following table shows the user fees that taxpayers must pay when submitting an APA request.

**Table 1 IRS APA Programme User Fee Schedule**

Taxpayer’s Action	User Fee Structure ( in US Dollars)
Filing of APA Request	50,000
Renewal of APA Request (Routine/Non-Routine)	35,000/50,000
Small Business(SBT) APA Request*	22,500
Renewal of SBT APA (Routine/Non-Routine) Request	22,500
Amendment to APA Request or Completed APA	10,000

\*An APA request is considered to be a small business APA request if the taxpayer has gross income of less than \$200 million or if the aggregate value of the covered transactions does not exceed: (i) \$50 million annually and (ii) \$10 million annually with respect to covered transactions involving intangible property.

<sup>31</sup> Rev. Proc. 2006-9 contains a detailed list of information and documents that must be included in and/or accompany an APA request.

The taxpayer must file an APA request by the statutory due date of its Federal income tax return for the first APA year covered by the request (or, if the taxpayer obtains an extension for filing its income tax return, by the actual filing date of such return). For this purpose, the IRS will treat the date the taxpayer pays its user fee as the date the APA request was filed, provided that a 'substantially complete' APA request is filed within 120 days of the tax return due date (including extensions).

#### Post-filing meetings with the IRS and providing response to the IRS

Once the APA request is filed, the APA Programme's policy is to hold an initial meeting with the taxpayer within 45 days of the assignment of an APA team leader to the case. In advance of the first meeting, the IRS submits a set of questions to the taxpayer, which generally must be answered in writing and are discussed at the meeting.

Concurrent with the initial meetings, the taxpayer and the IRS APA team agree on a case management plan, which provides for mutually agreed milestones for resolving important issues as well as dates and times for prospective information requests, meetings, site visits, and interviews.

#### Developing a recommended negotiating position (RNP).

The IRS APA team prepares a draft analysis stating the IRS position with respect to the taxpayer's transactions. Taxpayers are expected to submit written responses to the same, identifying the items that are acceptable and that require further development. Thereafter, there are follow-up discussions. In the case of a unilateral APA, the IRS draft and the taxpayer's comments become the basis for the final negotiation to reach an agreement on APA. In the case of a bilateral APA, the draft analysis takes the form of RNP. Based on discussions with

the taxpayer, the IRS develops a final RNP and any reservations or disagreements the taxpayer may have are recorded in the file and shared with the U.S. Competent Authority.

#### Competent authority negotiations

In the case of a bilateral APA, the U.S. Competent Authority will prepare a negotiating position based on the RNP and present the negotiating position to the foreign tax authority. Though the taxpayer typically remains actively involved in the process, the actual negotiations between the two Competent Authorities take place without the taxpayer present. Even the 'exchange of letters' describing the agreement between the governments is not disclosed. The taxpayer may learn the details of the Competent Authority agreement through discussion with the Competent Authority analyst handling the case or through a letter from the U.S. Competent Authority describing the agreement.

#### Finalising and signing the APA

The IRS APA team prepares and coordinates the draft APA with the taxpayer and once agreed, it is first executed by the taxpayer and returned to the IRS for execution by the U.S. government.

#### Annual compliance

The taxpayer must file with the APA Programme an annual report demonstrating that it has complied with the APA terms by the latter of two dates:

1. within 90 days after the Federal income tax return filing date for the year covered by the report; or
2. within 90 days after the effective date of the APA (there is some flexibility to this requirement where the taxpayer and the IRS may agree to different filing dates).

#### Cancellation and Renegotiations

Failure to file a timely annual report may result in cancellation or revocation of an APA. Fraud, misrepresentation or omission of a material fact, or mistake as to a material fact may also result in cancellation or revocation of an APA. While preparing an annual compliance report, taxpayers must carefully review all the critical assumptions under the APA and determine that they all still apply. If any critical assumption has been violated, then the taxpayer must notify the APA Programme. In 2009, the IRS and taxpayers executed 63 APAs and amended eight APAs.

#### Revising and Renewing APA

Executed APAs can be renewed. A renewal can take the form of a new APA (if facts and circumstances in a particular case have significantly changed) or of a routine renewal (if the facts and circumstances remain largely the same). In the latter case, the process may be resolved within a somewhat shorter time span. In the former case, it may take as long as the original APA.

#### Provision for Roll-Back

In the United States, the taxpayers generally may file a roll-back request asking the IRS to apply the APA's TPM to prior years. The IRS has discretion whether to consider and grant a roll-back request.

#### Latest Developments

The success of the APA Programme is attributable to its ability to evolve and match the needs of taxpayers and the IRS. Through revenue procedures, the APA Programme in the U.S. has been updated and expanded four times since its inception. Revenue Procedure 2008-31 is the most recent example. Some recent developments in the transfer pricing area that affect the APA process are as follows:

- The IRS extended the APA Programme to cover additional issues for which transfer pricing principles may be relevant, such as: (a) attribution of profits to a PE (b) determining the amount of income effectively connected with the taxpayer's conduct of a trade or business in United States and (c) determining the amount of income derived from sources partly within and partly without the United States, and related subsidiary issues.
- More taxpayers may seek certainty through the APA process because of the principles required to be applied in accounting for uncertain tax positions in audited financial reports, and because of a new tax reporting obligation requiring taxpayers to disclose uncertain tax positions to the IRS.
- Increased IRS transfer pricing enforcement activity may prompt more taxpayers to seek APAs. Transfer pricing compliance has been identified by the IRS as one of its priority initiatives, and the IRS is devoting increased resources and providing national-level direction to its transfer pricing enforcement efforts.
- Mandatory arbitration procedures under recent U.S. income tax treaties may have a positive impact on the bilateral APA process by facilitating the Competent Authorities' negotiations and accelerating the time to reach agreement between them.

## Key Learning

The experience of the U.S. with APAs has fundamentally been a very positive one for both the IRS and taxpayers. The programme has provided a vehicle for taxpayers and the IRS to resolve difficult transfer pricing issues through a process that is more cooperative, more principled, and less contentious than the traditional IRS examination process.

It is a voluntary programme, so each

taxpayer invoking the process has determined that the benefits of an APA outweigh the costs, and has made an institutional commitment to make the process work. An APA can offer flexible approaches to tackle uncertainty. For instance, an APA may measure the acceptable future results based on an inter-quartile range, offering some flexibility in the financial outcomes that will meet the APA terms. Use of critical assumptions, an annual report mechanism, and a limited term agreement assures that the agreement will continue to be appropriate under evolving facts.

The success of the APA Programme can be traced to number of other factors as well, such as (a) centralised, national-level staff, separate from the examination function, with authority to resolve significant issues; (b) active involvement of the IRS field examination organisation in the APA process to ensure the integrity of, and institutional support for, the programme; and (d) the creation of specialisation teams within the IRS APA office to handle cases arising in selected industries, which has allowed for the development of more specialised expertise within the APA office and has enhanced the consistency and efficiency of issue resolution for cases within the specified industries.

The use of the APA process to resolve transfer pricing issues is expected to continue to increase in the coming years.

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