

Meeting minutes of US India Strategic Partnership Form (USISPF) webinar on Advanced Pricing Agreements and Mutual Agreement Procedures

Date of meeting – 27 April 2022 8.30 pm to 9.30 pm (Indian Standard Time)

Speakers

1. Mr. Sanjay Kumar (Partner – Deloitte India)
2. Mr. Sobhan Kar (Senior advisor – Deloitte India)
3. Mr. Jamie Hawes (Senior Manager – Deloitte Tax LLP USA)

Host – USISPF

Overview

With a brief introduction of the speakers to the audience, the webinar began with providing an insight into the statistical overview of the progress of the APA/ MAP programme in India since inception, covering APA and MAP applications filed and cases concluded, also highlighting the preferred jurisdiction/ treaty partners of India. The panel also provided a comparative statistics of the US on the total APAs/ MAP applications filed and pending, the important treaty partners for negotiations, the industry players that have been opting for alternate dispute resolution mechanism and the commonly covered international transactions.

The panel explained that large number of multinational enterprises have been opting for APA and MAP over the years as an effective dispute prevention mechanism/resolution mechanism to :

1. Obtain tax certainty, and
2. To circumvent the time-consuming process under domestic litigation especially from the Indian perspective.

The panel then discussed some important aspects and issues under APA and MAP negotiations

Pre-requisites for taxpayers during APA negotiation

The panel highlighted that characterization of the taxpayer is of utmost importance. the taxpayers should have the clarity and necessary backup to justify its business characterization such as cost-plus low risk service provider or contract manufacturers or an entrepreneurial entity etc with respect to covered international transaction in APA and MAP

Apart from the above, taxpayers must have clarity and a clear line of reasoning on the treatment of certain items as part of the cost base specifically from a captive service providers' point of view. This could be in nature of Free of Cost services/ goods, treatment of foreign exchange fluctuations, Employee Stock Option Plans (ESOP), etc.

Royalty payment

The panel then moved on to provide insights into the approach adopted by India as well as US competent authorities for some specific transactions.

With respect to Royalty/ payment for intangibles, the panel mentioned that both India and the US competent authorities have been concluding on agreements for fixed rate of royalty as well as for variable royalty payments. However, under MAP, since the mechanism is more of a post facto arrangement, the negotiating authorities arrive at an equal ground on a specific percentage/ quantum of royalty rather than determining the compensation model as a whole.

with respect to variable royalty, the panel further explained that the concept is largely based on profit split and different approaches have been followed such as royalty step up, fixed percentage upto a certain profit level and proportionate increase in royalty payment thereafter, etc.

Intragroup service (IGS) charges

Intra Group service charge is another important transaction under India-US APA and MAP negotiations. Under MAP, the two competent authorities negotiate and agree for a partial allowance of payment. There have been cases wherein even upto 70% of the IGS payment was agreed by the competent authorities as compared to Nil IGS payment alleged by the Indian tax authorities. Under APA however, since the arrangement involves determination of the appropriate pricing mechanism, the authorities undertake a study of the global policy of the Multinational Enterprise regarding (1) the scope of services being included under the ambit of IGS and the nature of services that are excluded or classified as shareholder services, (2) the cost identification and cost allocation methodology, (3) number of service provider and service recipient entities of the group etc. Further, in few cases, competent authorities have also agreed for the entire amount of IGS subject to an upper cap. For example – any quantum of payment is allowed provided it is subject to a maximum cap of 2-3% of sales. It may be noted that for both APA and MAP negotiations, the competent authorities would expect for robust documentation clearly demonstrating the receipt of these intra group services and justification for their need and benefit.

Permanent Establishment (PE)

Panel also discussed another important issue faced by the US MNEs in India i.e. existence of PE. In the past, there had been situations under MAP wherein competent authorities did not find a common ground on the very existence of PE, however still agreed on the attribution of profits. With this being said, the panel mentioned that under MAP, India-US competent authorities have been very receptive, and efforts are made to determine whether any PE exists judiciously and if yes, what could be the appropriate profit allocation basis.

Under APA, the authorities are yet to finalize the method used for allocation of profits to a PE if the negotiations result in the fact that indeed a PE exists. However, taxpayers should also bear in mind the favorable jurisprudence that exists under domestic litigation from an Indian perspective on the aspect of existence of PE and resultant profit allocation.

Private Equity entities and the aspect of carried interests

In India, APAs were negotiated and concluded for non-binding investment advisory firms at a cost plus 20% markup or above over the years. However, in recent years, the discussion started on the concept of carried interest. The Indian APA authorities were intending to include the amount of carried interest in the cost base of Indian entities for determining service fee on agreed cost-plus basis. However due to paucity of such data, the negotiations were stuck. Subsequently, the Indian competent authority agreed with the US competent authority to step up the cost of Indian entity, based on a normative percentage of employee cost to compensate for the carried interest.

Fiscally transparent entities

From the US perspective, one important aspect is to ensure that the contracting entity is not a disregarded US LLC. Indian authorities had initially concluded APAs entered into by fiscally transparent entities but later realized that they do not satisfy the definition of “person” under Article 4(1)(b). Hence, India pushed for amending the treaty via the protocol whereas the US insisted on having a memorandum of understanding in place for such cases. This particular issue is yet to be resolved as of date.

Refund of excess tax withheld in India for non-resident taxpayers based on arm’s length price agreed in APA and MAP

The panel discussed the consequent issue of withholding tax for the US entity in India after the conclusion of APA and MAP. A situation may arise wherein the Indian entity agrees on a transaction whose arm’s length price under APA may be lower than the actual transaction value. For example – Royalty payment made at 7% is concluded at 5% under APA. In this scenario, the foreign entity who has already been subject to withholding on the said 7% in India, is naturally entitled to the refund of excess taxes earlier deducted. The relief for such a situation is to apply to the CBDT under Section 119 of the Income Tax Act, which is a cumbersome and time-consuming process.

Instead, it was suggested that a second/ parallel APA application by the US entity in India, along with the main application filed by the Indian entity, can be explored by the US entity which would allow an opportunity to the US entity to claim the excess taxes withheld as refund through modified tax return procedure under the Indian domestic law .

Acceptance of foreign tested party in APA and the documentation needed to strengthen such position

It was mentioned that the APA authorities are very receptive on this issue of benchmarking the foreign party as tested party. APA authorities adopt a fair strategy wherein the least complex party to the transaction is to be used as the tested party. In terms of documentation, the benchmarking exercise is key to justify the same.

The role of the regulators in a highly monitored tax environment wherein the margins retained in India are constantly scrutinized

The panel mentioned that APA authorities are not guided by the regulatory authorities and hence are having the powers to conclude and arrive at the arm's length price for a transaction irrespective of the regulatory norms. However, the taxpayer must evaluate the viability of an APA if the regulatory norms are intervening on the covered transactions.

Treatment of sub-contractor costs forming part of Indian company's cost base

Though the US authorities were not receptive of including the sub-contractor costs in the overall cost base, since there was a profit element already embedded in these costs, the Indian competent authorities have found success in convincing the US counterparts for inclusion of such costs. However, discussions on these issues are fact specific and shall require deeper analysis.

Outlook of the APA authorities wherein third-party services acquired by group company and provided to the subsidiaries in India

For cost plus entities, many items are added to the cost base which would also include such services as well. Hence APA authorities may insist on such services be allocated to the Indian entity. Therefore, the treatment of this arrangement would depend on the characterization of the Indian entity.

.....

Private & Confidential