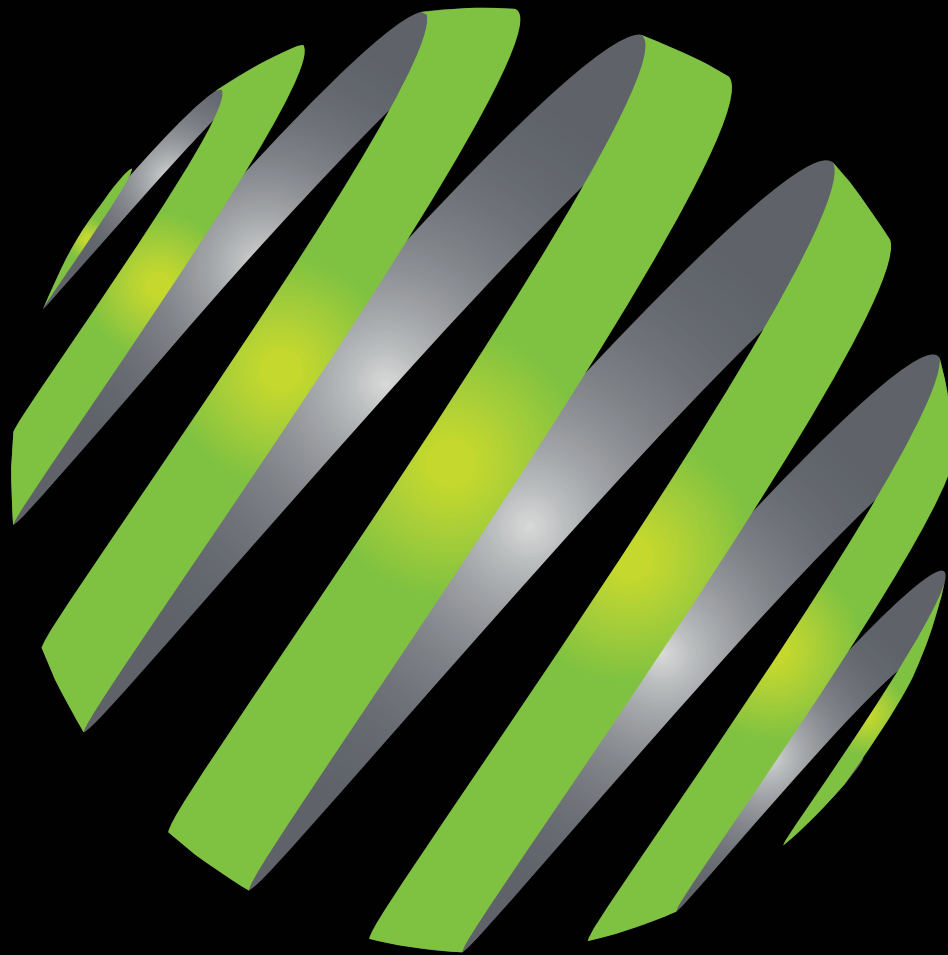


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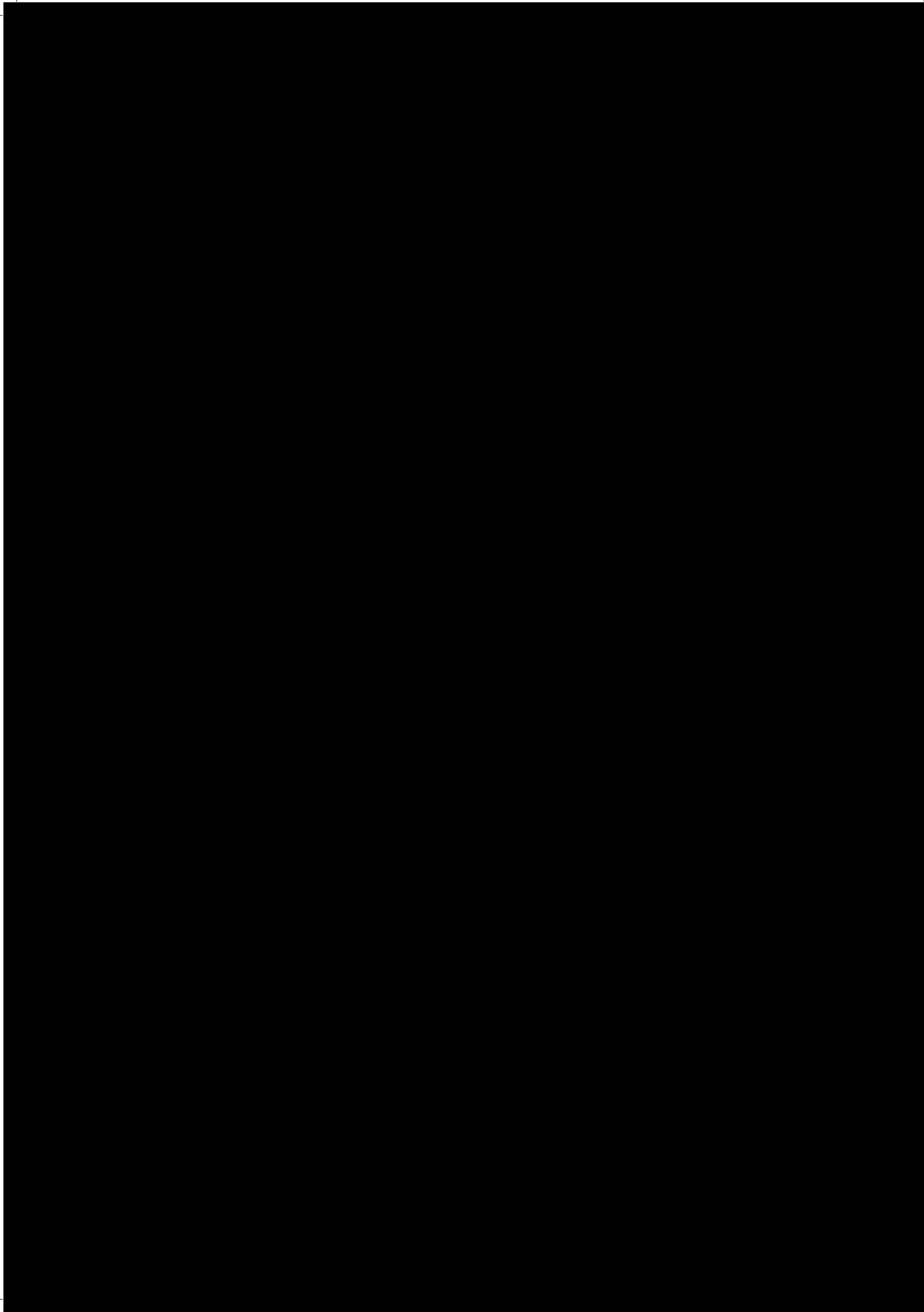


**Indian Advance Pricing Agreement Programme  
Evaluation and Way Forward**

Deloitte Tax Policy Paper 2

For private circulation only

October 2018



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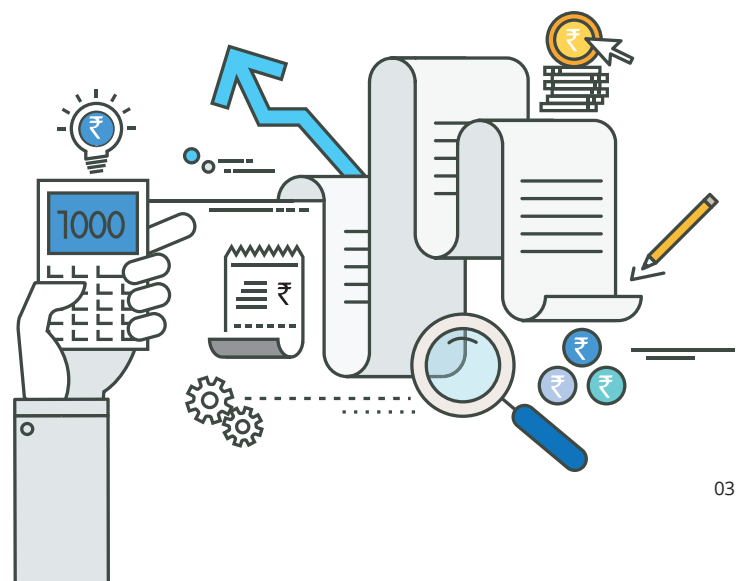


# Executive Summary

The Indian government introduced the Advance Pricing Agreement (APA) programme about six years ago with the objective to provide much needed tax certainty to multinational enterprises (MNEs) operating in India, particularly on their intra-group transactions, and in the process, adopt global best practices. Six years down the line, the programme has attracted considerable popularity with foreign investors as indicated by the fact that nearly 1,000 APA applications have been filed and close to 240 APAs signed.

Credibility of a tax administration depends to a large extent upon the efficacy of its dispute resolution mechanism. Dispute prevention has an equally important role in dispute management. In ensuring that avoidable disputes do not occur, APAs have stood out as a model for dispute prevention. Initially the APA programme did not have roll back provisions, but they were added to the programme after tax authorities realized the overall benefit. All these changes have made the APA programme very popular and successful. But as it happens in any programme, the APA model needs to evaluate itself and recalibrate appropriately.

This tax policy paper, second in line for 2018, is an attempt to evaluate and provide the way forward with an objective to improve and bring robustness to the APA programme. The paper provides more than 22 recommendations, covering procedural aspects of the APAs, post-compliance procedure of APAs, and also on legal and other aspects. Hope the paper brings some important takeaways for tax policy group and taxpayers, and helps in taking a step further to improve the 'Ease of Doing Business' - by providing further tax certainty.



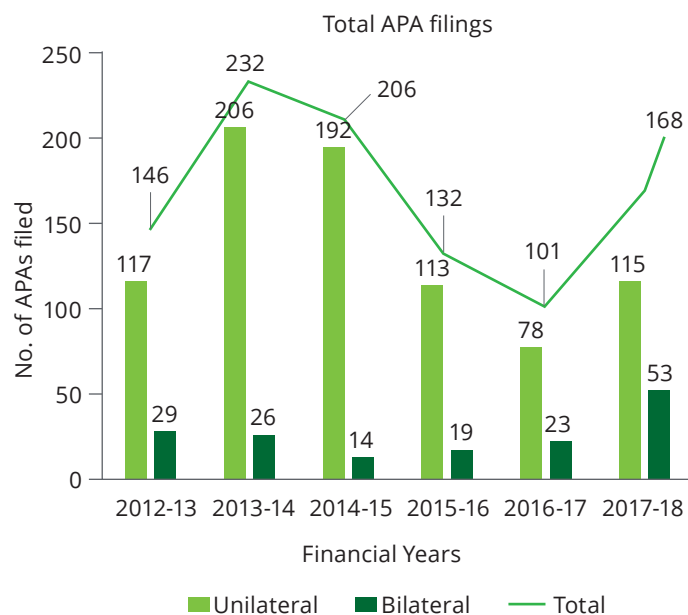
# Background

The APA programme has been a key dispute prevention mechanism in the Indian direct taxes set-up. Valid for only international transactions within a MNE group, the APA programme has, in six years, attracted 985 applications, up to 31 March 2018. Of these 985 applications, 219 applications were finalized towards APAs,<sup>1</sup> providing certainty to these MNEs.

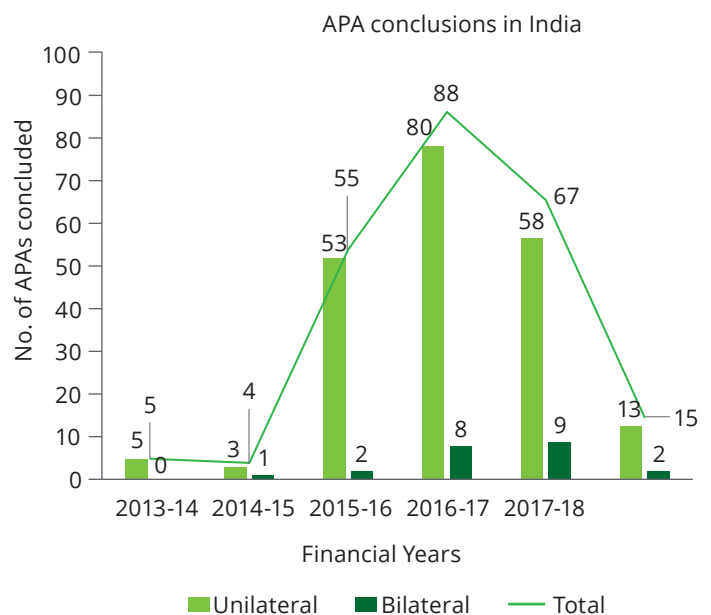
The Indian APA programme provides for all three kinds of APAs - unilateral, bilateral and multilateral.<sup>2</sup> However

no multilateral APA application has been received so far, with the maximum number of applications for unilateral APAs (788 out of 985 applications) and the remaining 197 applications for bilateral APAs. While conclusion of APAs was slow in the initial years, likely due to teething procedural aspects, it picked up significant momentum after the third year. Impressively, in the last six years to 31 March 2018, the government has concluded 199 unilateral APAs and 20 bilateral APAs. Graphs 1 and 2 indicate APA filings and conclusions for each year of existence.

**Graph 1: Year-wise APA filings**



**Graph 2: Year-wise APA conclusions**



Source: CBDT APA annual report FY 2017-18

<sup>1</sup> CBDT's APA annual report FY 2017-18. After March 31, 2018, there have been close to about 20 more APA conclusions, covering both bilateral and unilateral APAs.

<sup>2</sup> Transfer pricing is the price paid for goods transferred from one economic unit to another, assuming that the two units involved are situated in different countries, but belong to the same multinational firm. Income tax rules re-determine those prices through five specified methods, and thereby reduce or annul any reduction in the taxable base in its country. These are highly contested, and result in disputes. APA programme, being a dispute prevention mechanism, tries to give ex-ante the price of those intra-group transactions. Transfer pricing adjustments may also result in double taxation – called economic double taxation. Bilateral APAs and multilateral APAs try to remove those double taxation through treaty negotiations. Unilateral APA gives domestic taxation certainty, but does not ensure double taxation relief.



The applications filed cover all three-business sectors – manufacturing, trading and services. But a majority of the applications are from the service sectors, with a large proportion from the information technology business. This skewness is understandable given that the IT industry contributes around 7.7 per cent of the country's GDP and IT services and BPO together constitute 45 per cent of the total Indian service exports.<sup>3</sup> This sector also suffered a number of transfer pricing disputes with huge tax adjustments, after transfer pricing regulations were introduced in India in 2001.<sup>4</sup>

One trend that is becoming discernable, of late, is the increasing proportion

of bilateral APA applications. Earlier, majority of the APA applications, about 85 per cent, were unilateral; but during the last three years, the proportion of bilateral applications has increased from 14 per cent to 32 per cent. This change may be on account of two developments' - often, parent companies overseas do not get the full benefit of the unilateral APA resolution of their Indian subsidiaries in their tax jurisdictions, leading to overall double taxation. The other reason is that the Indian government recently relaxed its erstwhile stringent position of negotiating bilateral APAs only with the countries where Article 9(2) or its equivalent, exists in the double tax treaty with that country. This relaxation

has increased the scope of bilateral APAs with several tax treaty countries such as Germany, France, Italy, Belgium, etc.<sup>5</sup>

These changes do demonstrate flexibility in the approach of the Indian government in understanding business realities. All these go to enhance the effectiveness of the APA programme. It does go to the credit of the Indian tax authorities that till date there has been no reported failure of APA negotiations. Even reviews of concluded APAs are almost none.<sup>6</sup> The CBDT in its recent annual report 2017-18 has also mentioned that its endeavor is to reach effective conclusion of APAs and not to take harsh steps such as cancelling the APA.

<sup>3</sup> Indian IT-ITeS industry revenue is estimated at US\$ 151.0 billion in FY 2017-18 as compared to US\$ 141.0 billion in FY 2016-17, registering a growth of around 7.0 per cent. Industry's export growth (CAGR) over last five years has been 10.49 per cent. (Source: IBEF report on IT and ITeS issued in January 2018)

<sup>4</sup> The APA programme was introduced in 2012, after nearly 11 years of introduction of the transfer pricing regulation in India. Safe Harbor scheme was brought in 2013. The two dispute prevention mechanisms were brought in somewhat late. Absence of that gave no succor to the foreign investors from the aggressive transfer pricing litigation in India. Launch of these two schemes were able to provide the much tax certainty to the global investors. The Safe Harbor scheme in its first version did not find many takers and so was rationalized in 2017. So, between the two dispute preventing mechanisms, APA programme has been more successful, giving more acceptable and satisfying outcomes / conclusions.

<sup>5</sup> India does not have Article 9(2) in its DTAs with certain major trading partners including Belgium, Germany, France and Singapore. In the absence of Article 9(2), Indian government had so far followed the practice of not admitting cases of economic double taxation under its MAP and for bilateral APA negotiations. CBDT in its press release, dated 27 November 2017, reversed its earlier positions and stated that it would accept applications for bilateral APAs and MAP for transfer pricing cases irrespective of existence of Article 9(2) in its tax treaty.

<sup>6</sup> It is understood that two APAs, during their compliances, were referred to the CBDT for review as the assessing officer/TPO felt that there were some breach of critical conditions. But, in both case cancellation of APAs have not been recommended.

Having had run the APA programme for 6 years and having concluded more than 200 APAs, Indian tax authorities have gained substantial experience on the business models covering large and varied international transactions. Bilateral APAs with treaty partners such as the US, the UK, Japan, China, Switzerland, the Netherlands, Sweden, Denmark, etc., have given the Indian government sufficient experience. The speed and accommodation arrived at by Indian tax negotiators has surpassed many treaty countries in conclusions of APAs.<sup>7</sup> With such quick progress, India may soon be regarded as having a matured APA programme!

But as we all understand, the success of every scheme or programme hinges on its periodic review and iterative improvements. Continuous quality and process improvements are foundational approaches to improving the delivery. Gaining valuable learning and knowledge and using them for improvement of a product or process are part of systematical and continual improvement of any process or product. The Indian APA programme also needs to undertake that. Many matured APA programmes in various tax jurisdictions have undertaken similar such exercises. Australia, for example, has been reviewing its APA programme periodically. The first comprehensive review took place in 2013. The US IRS has also reviewed its APA programme and introduced the revised APA programme in 2015. Many tax jurisdictions, such as China and Japan, introduced annual reports on the performance of their APA and MAP programmes. These annual reports are important to get a holistic view on the progress of APA programmes and

could provide the basis for review of the programmes. Japan and China have also reviewed and revised their APA programmes from time to time. CBDT has also brought out annual reports – two so far – on APA and MAP. It is hoped that these annual reports would provide a basis for similar iterative review of the APA programme, in line with other tax jurisdictions.

This paper discusses some key aspects of the current APA programme and provides suggestions. We hope the paper will provide the policy-makers with taxpayers' perspective, which is useful in recalibrating the existing APA programme. The review covers three broad categories: review of APA procedures, review of APA compliance requirements, and review of the APA programme and the law. Each of these categories have been discussed in separate sections.

#### A. Review of the pre-APA procedures

##### 1. Using e-filing mechanism

The Indian government has already moved to e-filing mode for various compliances, be it annual tax return filing, withholding tax return filing, etc. Recently, it also commenced e-assessment procedure, and allowed online filing of all submissions to tax authorities during an audit process. Even appellate procedures have moved to e-mode. The APA programme is a major initiative of the government. Currently, it requires all filings to be done on paper, be it the initial application or the subsequent information such as responses to questionnaires or other submissions. Sometimes, these filings are in multiple copies.

All these create huge burden even on record keeping and record maintenance. With large APA applications, of close to 1,000, one can imagine the challenge at both taxpayers' and tax administration's ends, to handle and maintain these voluminous documents/records on a year-on-year basis. It will thus be perfectly in line with the current government programme, to allow e-filing of APA applications and subsequent documents. This would help authorities make use of data for internal management, resource planning, policy decisions, etc.

##### 2. Augmenting APA teams

Though the disposal of the APA applications, either through conclusions (219 APAs) or otherwise (82 disposed off for varied reasons), the inventory of APA applications continues to be large; 684 as on 31 March, 2018.<sup>8</sup> Such large inventory puts undue pressure on existing APA teams and often delays the process. APA renewal cases also seem to suffer due to these reasons.<sup>9</sup> There are also some APA applications filed during the earlier years of the programme, which are yet to be concluded. In these cases covered APA period may have also expired. This has created challenges for taxpayers, and surely for the government. Pendency of APA cases for each year is given in Graph 3. With more applications coming for bilateral APAs, as the shift in APA filings trend suggests,<sup>10</sup> the responsibility to deliver them timely for meaningful engagement with treaty partners would present another set of challenges for the APA authorities.

<sup>7</sup> Countries like Japan and the US are the far more experienced tax jurisdictions, having had APA programs for almost three decades. Indian APA program, despite being young in its existence has shown tremendous speed and understanding, and reached almost at par with the US at least in concluding APAs every year. During the year ending March 2017, India concluded 88 APAs, and US 86 APAs. India concluded its first bilateral APA with Japan very quickly.

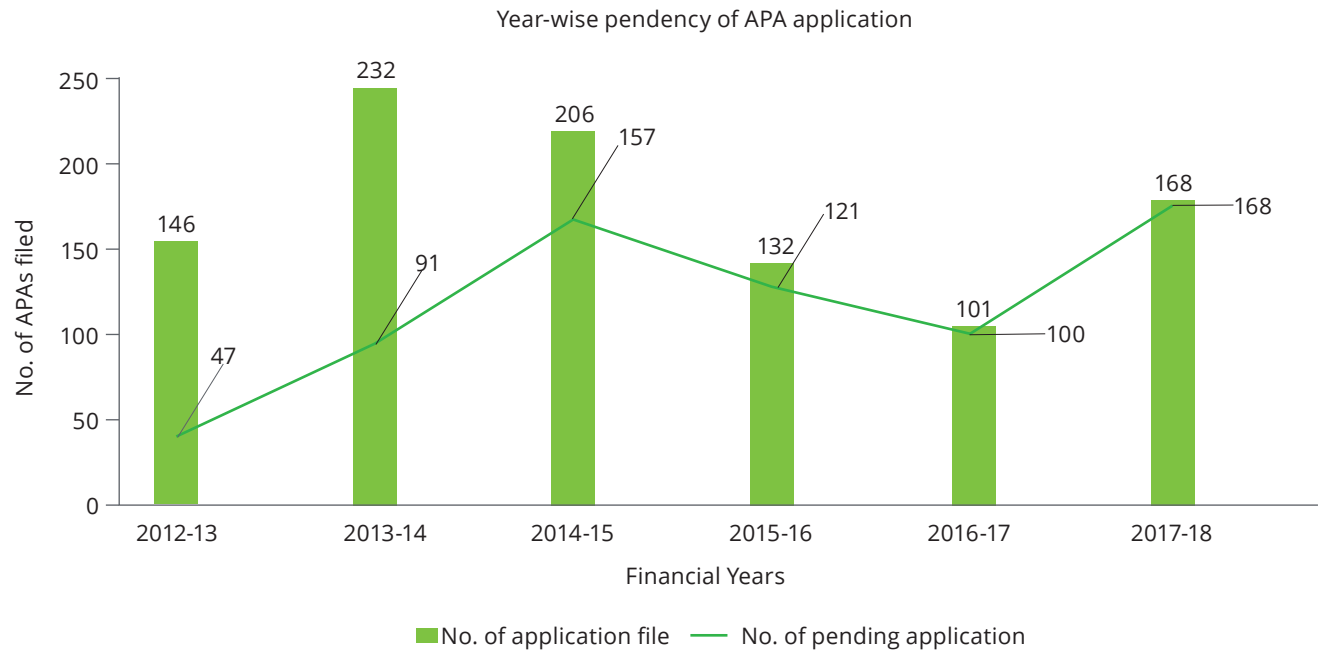
<sup>8</sup> APA Annual report *ibid*

<sup>9</sup> APA renewal cases have started being filed from FY 2017-18, as many APAs have concluded their stipulated five years.

<sup>10</sup> It may be pointed out that conclusion of each APA results in removing transfer-pricing disputes in 9 assessment years.



**Graph 3: Pendency of APA cases**



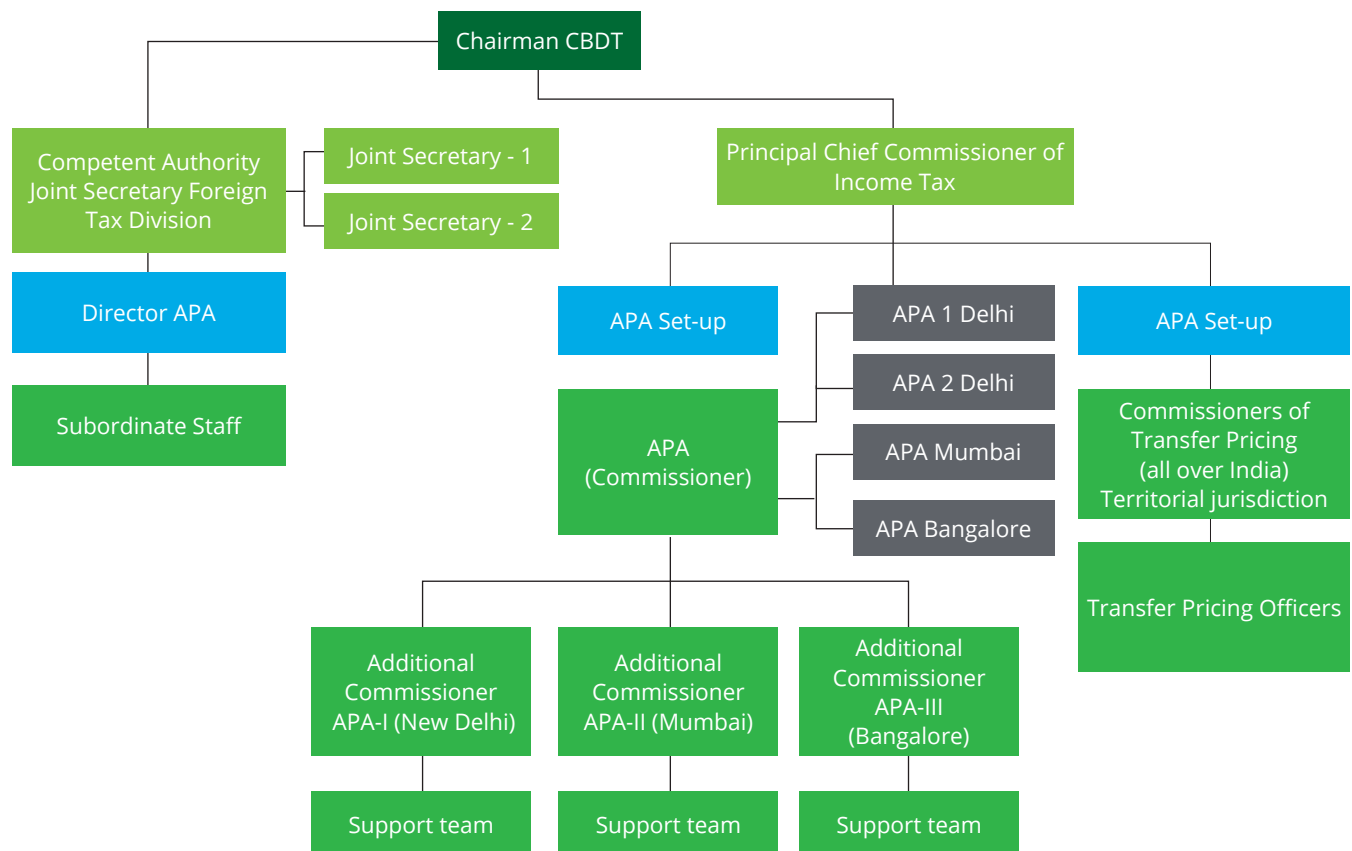
Source: CBDT APA annual report FY 2017-18





**Sufficient resources:** It is therefore crucial that sufficient resources are put in the APA programme, both at the APA commissioner level as well as at the competent authority level. Currently, India has only 4 APA commissioner teams, and two competent authority teams to review all unilateral APAs and negotiating bilateral APAs. Though both teams have been expanded recently, but the general experience is that they are still insufficient. This aspect has also been recognized by the CBDT in its APA annual report 2017-18. The current APA team structure is given in Diagram 1.

**Diagram 1: APA team structure in India**





Japan has the oldest APA programme. The Japanese government expanded its APA team and resources from time to time, considering backlog of the cases. Currently, the Japanese National tax Authority (NTA) has more than 40 officers in its teams looking at APA and MAP. Similarly, the US APMA has a large team with almost 12 sub-teams looking at various APA cases. Thus increasing the resources in the APA programme (MAP included) is important for strengthening the programme.

**Appropriate skill and stability of tenure:** Augmenting the number of officers in the APA team is necessary, but certainly not sufficient. For effective outcomes, tax officers with requisite skill sets and experience in transfer pricing cases, should be appointed and certainly for a stable tenure. While transfer pricing cases are specialized in many ways, the APA with all its projections and foreseeing business transformations, scaling up or introduction of new transactions during the APA covered years, can certainly present its own challenges. So, appointment of inexperienced officers or frequent transfers or shifting can render the system ineffective. Stability of tenure may allow officers to invest time and

resources on every case and carry out detailed analysis. This will also help in expediting the APA process once the officer concerned has sufficient learning.

**Multiple subject matter experts:**

Transfer pricing analysis is anchored in functions, assets and risks (FAR) of the business and economic analysis of the business and transactions provides requisite analysis on arm's length price of international transactions. Transfer pricing is far from a settled, business-as-usual area of tax. The new understanding gaining ground, particularly after BEPS recommendations and its implementation through multilateral instrument (MLI), is of understanding the value chain of the transactions within the MNE group. In countries such as the US, the UK and South Africa, the APA teams include subject matter experts such as economists and industry experts in their teams, to understand better the complexity of cases. Canada APA teams comprise accountants, financial analysts, economists and lawyers. International transactions reported in APA, is no less in complexity and extent and so, the Indian government should also involve various subject matter experts to handle complex cases either

permanently or on advisory basis to assist APA teams in arriving at better and commercially justifiable APA outcomes.

**3. Internal guidance note or procedure manual**

As mentioned above, India has four APA teams, headed by a commissioner, each operating in a different region of the country, based on equitable distribution of workload, under the overall supervision of the Principal Chief Commissioner of Income Tax (International Taxation). Generally, though there is internal coordination between different teams, there are instances when it has been experienced that teams may take different technical positions on similar business arrangements covering identical/similar international transactions. This creates uncertainty for taxpayers and may often result in stalled APA negotiations. Since the work-distribution between different commissioners is on the basis of equitable distribution of workload, so there can be a case that same or similar business in the same location may result in different outcomes, and that often creates unfair comparison and dissatisfaction.

**Guidance for APA teams**

The APA programme has been in existence for six years and in the meantime has gained key experience and outcomes, which can be good guidance for outcomes under the APA programme. Some of these issues can be on allocation basis for business segmentation, treatment of operating and non-operating revenue and expenses, cash repatriation, interest for delayed repatriation, free of cost goods and services, employees stock option (ESOP) costs, platform cost from customers, etc. The CBDT can consider coming out with an internal guidance drawing upon lessons from the successful implementation of early engagements. Australia ATO’s internal guidance, PSLA-2015/4 issued in July 2015, is an example of such practice statement, providing guidance to the ATO staff in dealing with requests from taxpayers to enter into an APA. The objective behind this ATO initiative is to have a principle-based approach towards APA, streamlining the process and practices to improve timelines and reducing red tape. Such guidance could be issued to TPOs to avoid unnecessary litigation.

**Guidance for TPOs on post-APA compliance**

After conclusions of the APA, the TPOs, as per the Income Tax Act 1961, are required to review the compliance of the terms and conditions of each year covered under the APA to ensure that the taxable income for each covered year is in accordance with the APA. Sometimes, the TPOs get into unnecessary details resulting in duplication of efforts and wastage of time and resources. It is understood that TPOs have sent negative reports in almost hundred concluded cases that were found insignificant by the Principal CCIT (Intl taxation) or by the competent authorities. Therefore, in order to avoid unnecessary litigation, the guidance may be issued to TPOs



on review procedures that may be adopted for verification of details instead of detail scrutiny. Based on the experience of earlier reports of TPOs, a practice manual may be issued detailing the information and documentations to be reviewed by them. The information can be additionally asked in the rollback period and the APA covered period. If the tax computation based on APA is included in the Annexure to the APA, then that can substantially reduce the scope for any litigation. Currently, it is not followed as a practice but included only in some cases at the option of the taxpayer, if the taxpayer so provides. Moreover, the information is included only for the rollback years.

**Guidance for TPOs for assessments**

The APA program has taken principle approaches for APA conclusions, setting appropriate transfer pricing methods for arriving at arm’s length

prices for different business models. The experience gained out of the APA conclusions and the transfer pricing methods used can be a good guidance for the field transfer pricing officers. Chronicling them in a suitable manner and providing them as a practice manual would turn this valuable knowledge into a good guidance for the filed officers. The officers could use these guidance for their audit/assessment work.

**4. Reducing average time for APA conclusions**

The median time taken by APAs in India have been more compared to matured tax jurisdictions. The median time taken for conclusion of APAs in India are: unilateral APAs about 32 months, and 42 months for bilateral APAs. This is higher than other countries, which is 23 months for unilateral APAs and 27 months for bilateral APAs, as may be seen from Table 1.

**Table 1: Median time taken for conclusion of APAs**

Country	Unilateral APA	Bilateral APA
Australia	12.73	19.91
Canada	28.3	49.2
China	18	12
UK	--	25.75
Japan	--	28.9
USA	28.07	42.11
<b>Median</b>	<b>23.035</b>	<b>27.325</b>

Source: Different Country’s latest APA annual reports

Certainly, the Indian APA programme needs to be reworked for faster delivery. It may also be added here that 47 applications filed during the first year of APA filing, i.e., in FY 2012-13, and 91 applications filed in FY 2013-14, are still pending for conclusions (refer Graph 3). Reasons for non-conclusions could include lack of interest by the applicant. But what is important here is the need to have a review mechanism to evaluate reasons for such delays and to take steps to control them. In any case, if the time taken is longer than other countries, it calls for an overall review to streamline the process and improve on timelines by reducing bureaucratic delays. The ATO practice can be a good guidance in that respect.

**5. Fast tracking renewal APA applications**

India has started receiving applications for renewal of APAs. General expectation of taxpayers is that renewals would be faster

and would take much lesser time than the original process. The current procedure for the renewal of APAs does not provide for fast tracking the applications. Renewal application is considered similar to the fresh APA application and gets into the routine inventory. This may slow down the overall process and increase dissatisfaction among taxpayers. The process has to be streamlined and shortened so that renewal applications are not concluded in a manner akin to earlier APA applications. The government needs to recognise that renewal applications already have the advantage of earlier site visits and verification of facts, and compliance, post-APA conclusions. If the applicant while filing compliance reports post-APAs, did not report any change, material or otherwise, in its FAR during the APA years and which are accepted during the annual review process, there can hardly be any need to do a fresh processing of the applications.

In the APA renewal applications, it may also be pointed out that there would not be any rollback, but if there were any delay in the conclusion, it would result in secondary adjustment payments for taxpayers. This could be considered burdensome by taxpayers.

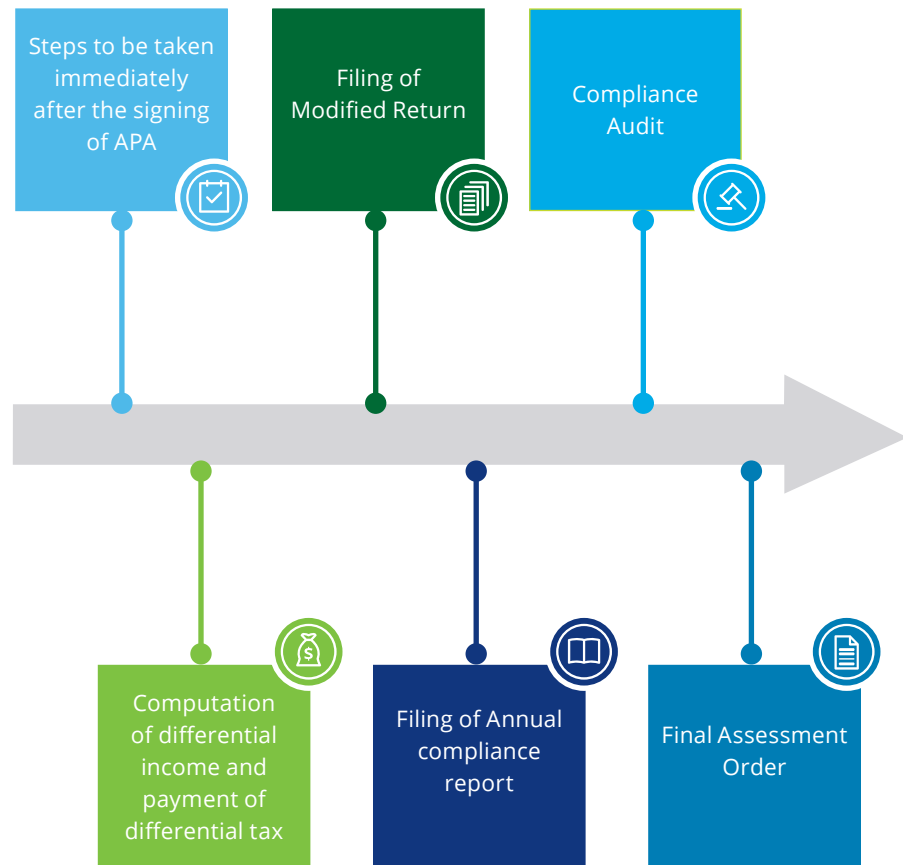
India should therefore lay down, a system for filtration of renewal cases that involve (a) simple roll over of the existing APA to future years, (b) change in facts and circumstances, or (c) requiring different terms and conditions, than existing APA with no change in facts. Based on such classification, the renewal APA applications could be segregated and separate teams could be assigned to look into the renewals that involve simple roll over of the existing APA with no change in facts and circumstances. It is understood that group of filings may be the largest one. This set of cases can be renewed easily without getting into normal inventory and the APA cycle.



**B. Review of post-APA compliance requirements**

The APA programme sets out detailed compliance procedure post-conclusion of the APA to ensure completion of the tax assessment for each of the covered APA years in accordance with the terms and conditions of the APA; diagram 2 outlines the process flow for post-APA compliance. But quite often, the approach that the transfer pricing officer (TPO) adopts while doing annual compliance review (ACR) is something which is more time consuming and burdensome than what would otherwise be required; TPOs start doing another full-scale audit. It may be mentioned that the APA team as part of the APA process, has already done pre-audit of the case and all their findings would have figured appropriately in the economic analysis of the case – the FAR analysis, which is often one of the annexes of the APA. Therefore, any extra effort by the TPO may just be a duplication of the earlier work, and very frustrating for taxpayers. This also demonstrates lack of trust between the taxpayer and the department, whereas the APA is supposed to build just that.

**Diagram 2: Process flow for post-APA compliance**



Considering the above scenario, it would be important to consider how filings can be reduced without compromising on compliance and information flow. It may be pointed out that taxpayers are required to file annual compliance report to tax authorities for each year separately, covered under APA. This is a comprehensive report covering details on international transactions covered under APA. These details cover name of the transacting AEs, nature of international transactions, TP methodology and the price charged. After all these filings, the taxpayer is also asked to file Form 3CEB, which covers international transactions, name of the AE, price



<sup>11</sup>. Based on our practice experience.

charged/payed, etc., and maintain usual TP documentation, that is duplication of the same filings covering the same information. During the APA process, the APA authorities through site-visits and detailed documentation already would have analysed the FAR profile of the taxpayer, and fixed TP methodology, including the arm's length price of the international transactions. They can definitely be given some relief on filing requirements without compromising on information flow, so that the tax administration has full view on the activities or functions of the taxpayers.

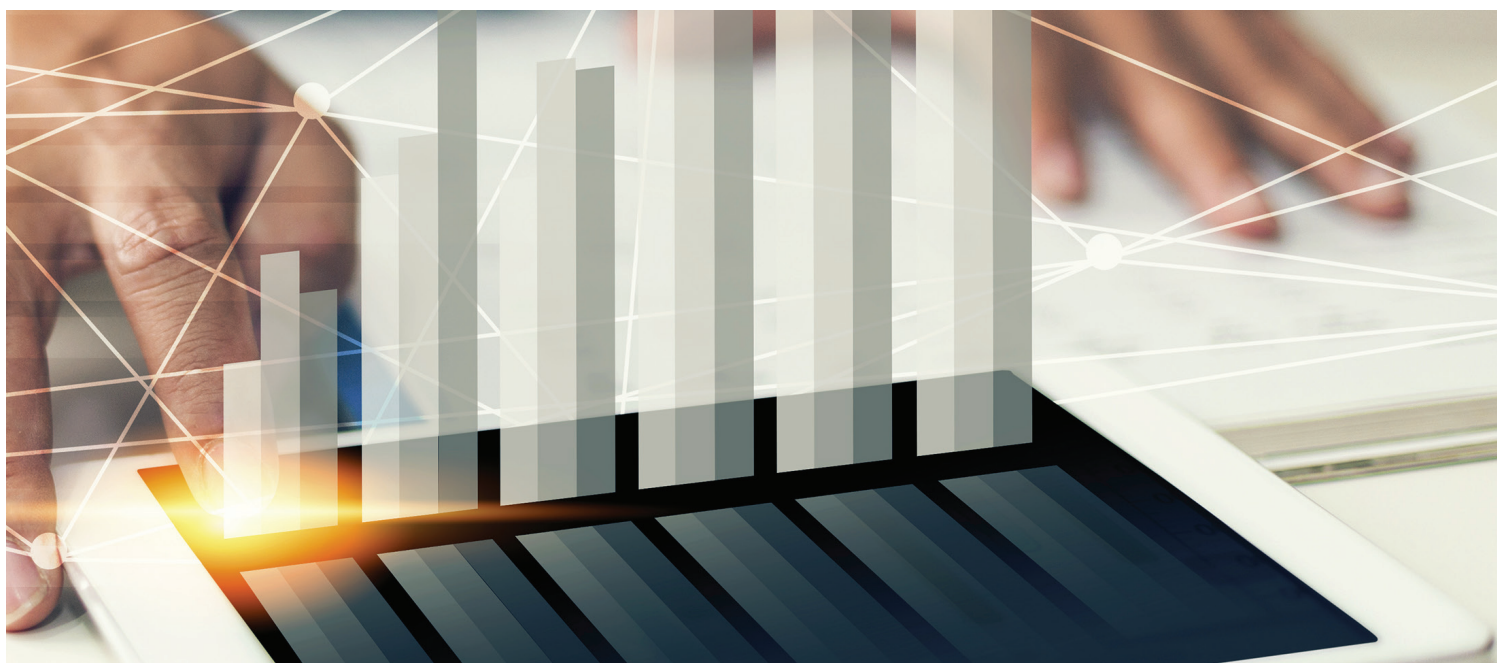
Normal documentation could be insisted only in those cases, where not all international transactions were covered in the APA. But such cases are very few. Most APA applications cover all international transactions of the entity.

There are also cases where the TPOs report insignificant non-compliance.<sup>11</sup> Such nit picking can be

an anti-thesis to the overall regime of the APAs. APAs are meant to provide certainty, not only on tax demand but also on the processes. APAs necessarily cover some critical assumptions, which provide for some tolerance to minor changes in the business, without "material" changes. The TPOs need to recognise those changes and take a broad view of the matter. Reporting minor changes to higher-ups does create a flutter in the mind of taxpayers, and can be deleterious to the overall faith of taxpayers in the APA, which is supposed to provide certainty. In this regard, one needs to thank senior officers of the department who have shown sagacity and openness, which has resulted in not many cases being processed for review by the CBDT.<sup>12</sup> Even the process of raising of issues by TPOs to senior levels, do lead to some flutter and unnecessary harassment, affecting the robustness of the APA. It also defeats the overall process that was supposed to be a compliance audit, but turns itself to a rigorous audit on minor, allowable changes that are not substantial or

"material". It would thus be in order for the CBDT to issue a guidance note clarifying the scope of the compliance audit to the transfer pricing officers. This guidance note could be on the procedures to be followed by the TPO for information requirement, documentation review and the computation of the arm's length price (ALP) in accordance with the APA. The guidance may also include the situations of material change.

Many tax administrations, like the Canada Revenue Authority for example, also arrange a post-settlement meeting to discuss terms of settlement, renewal considerations, timeliness of the process, and any problems encountered during the process. This stage is intended to give both parties the opportunity to provide and receive feedback on their experiences and concerns, and to make sure that the process is continuously updated and improved. Such open compliance process would add robustness to the programme.



<sup>12</sup> From a public statement, it has been learnt that out of more than hundred cases with negative report from the TPOs, only two cases have been sent to the CBDT for review.

### C. Legal and Schematic Review

In the foregoing we have largely attempted to look at the procedural changes in the APA programme with a view to make the programme robust and more acceptable to taxpayers, thereby making it comparable or even better than the APA programmes in other tax jurisdictions. But such procedural reforms would be incomplete unless they are accompanied or are part of some imperative legal changes. These changes in law governing the APA programme would ensure that changes achieve efficiencies and provide flexibility consistent with the beneficial purposes of the programme. The suggestions are meant to articulate aspirations of the existing or prospective APA applicants and are intimately linked to the promotion of the rule of law.

#### 1. Additional tax for no-cash repatriation

Almost all APAs concluded so far contain mandatory conditions for cash repatriation for rollback years and past covered APA years. In few cases where it was difficult for taxpayers to transfer funds for transfer pricing adjustments due to regulatory restrictions in AE's country, the taxpayers were asked to offer additional income over and above the transfer pricing adjustment as a compensation for the loss of taxes. This, it is understood, was based on the premise that if the cash were repatriated to India, it would have formed part of the taxpayers' financials and could have resulted in dividend distribution tax at the time of paying it back to the MNE group. In order to compensate for the loss of capital and taxes, the additional income is required to be offered by taxpayers in case of non-cash repatriation.

While one may agree to the overall cash-repatriation given the government policy to augment forex reserves, it may

be worthwhile to consider it as compensatory and not link it through the current formula based on dividend distribution tax. The compensation could be calculated as additional taxable income based on loss of interest on such funds and corresponding taxes to India. The present formula often results in more than 50 per cent additional taxable income for past covered years, and substantial tax cost for taxpayers. The suggestion therefore is for an alternative practical and less burdensome basis for compensation in the absence of cash repatriation, such as one-time tax on notional interest for a particular assessment year.

#### 2. Business restructuring considerations

Businesses are dynamic and mergers and acquisitions are facts of business expansion and deepening. APAs also need to recognise those changes and bring themselves in sync with business realities. The present APA programme does not allow for all business restructuring that may take place subsequently. CBDT circular (No. 10/2015) provides rules through FAQs to cover cases of mergers/ demergers. Question nos. 13 and

14 of the FAQs state that the APA applicant would be eligible for the benefit of APA in a very restricted manner.

No doubt, advance price under APA is arrived at for a particular international transaction and for a particular business arrangement between the two entities. One can argue that the FAR changes when the entities change. But if international transaction is taken as the basis for giving the benefit of APA, and not the entity, it can capture business dynamics more realistically. The only caveat could be that the terms and conditions of the business arrangement do not change substantially through business restructuring. Many advanced tax administrations provide sufficient width to APA applicants and cover the cases of mergers and acquisitions adequately. They take into account the international transaction(s), which continue to remain same even if a company merges or demerges. The only condition being that the merger or demerger do not have had any material effect on the transactions with the associated enterprises.





**Conversions into LLP**

The CBDT does not allow an APA application to proceed if there is subsequent conversion of a company into LLP. The Limited Liability Partnership (LLP) Act, 2008, introduced by the government in January 2009, was aimed at promoting investment inflows from global investors. After the introduction of LLP, many companies have been converted into LLPs. The LLP structure is a combination of partnership and company, and undertakes significantly lower number of regulatory compliances than a company. Besides, there is no dividend distribution tax on LLP and that is one of the main reasons why many consider it to be a more efficient structure for investors. Dividend distribution tax in India is 20.6 per cent.

But there are instances when the CBDT has not agreed to an APA application to have subsequent conversion of the company into LLP. In such cases, there is no change in

the business operations and only the form of the entity is changed. Such a position may be considered restrictive and can hamper a dynamic business environment.

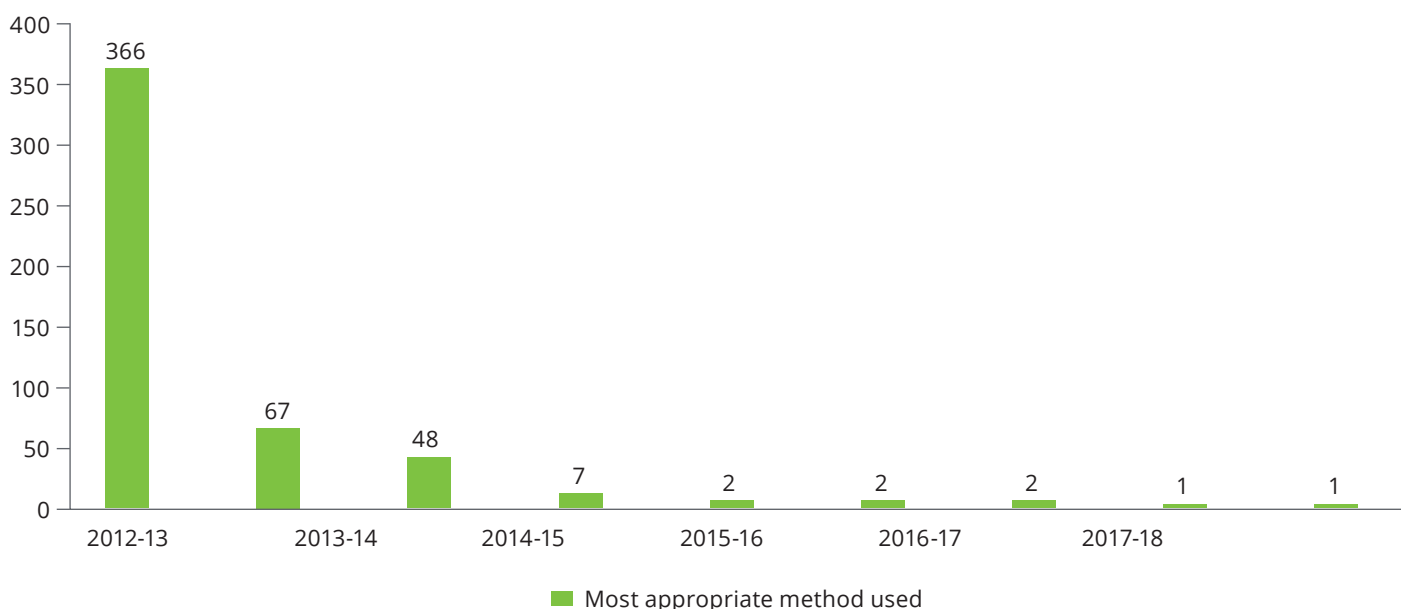
Paragraph 11 of the Third Schedule to the LLP Act, 2008 allows conversion of the existing entity into LLP. It states, "...all contracts, agreements, applications, schemes, instruments and arrangements, etc. in relation to the Company or to which the Company is a party shall continue to be in force". Thus, all applications to which the company is a party, shall continue to be in force and would be enforceable by or against the LLP. By implication, it would be in order to assume that the above provision would also cover the APA application and subsequent conversion to LLP. Contrary to that would not be in the spirit of the legislation. But the CBDT probably relies on Section 170 of the I-T Act and considers that conversion of existing APA application should not be allowed into LLP. Given the overall objective of the LLP Act and

also the APA programme, it would be in order to allow conversion of a company into LLP.

**3. Use of complex TP methodologies**

APA annual report, 2018, issued by the CBDT, states that the transactional net margin method (TNMM) has been overwhelmingly used (in 73 per cent of transactions) in the APA programme for determination of arm's length price of covered transactions. Other methods of transfer pricing have been used rarely. They include the comparable uncontrolled price (CUP) method for 8.5 per cent of the covered transactions, cost plus method (CPM) for just 4 transactions, and resale price method (RPM) in only 2 cases. In some cases, the profit split method (PSM) has also been used. One would have expected that more appropriate transaction methods would be used, instead of profit-based method such as TNMM. Frequency of the methodologies used in APAs is shown in Graph 4.

**Graph 4: Frequency of transfer pricing methods adopted in the APAs up to FY 2017-18**



Source: CBDT APA annual report FY 2017-18

Although TNMM is widely used, it is however not supposed to be a primary method. TNMM requires transactions to be “broadly similar” to qualify as comparable. “Broadly similar” in this context means that the compared transactions do not have to be exactly like the controlled transaction. APA process involves detailed documentation as well as site visit, and so one would have expected that APA authorities would use more direct transfer pricing methods instead of overall profit based method. There are situations when details furnished by taxpayers reveal that functions are more of a distribution and there is very limited value addition. In such situations, using TNMM or net margin level

profit indicator instead of gross profit basis for comparison can defeat the entire purpose of the APA programme. The TP method should be more commercially suitable. It should be the endeavour of APA officers to use more economically and commercially justifiable TP method, and not a method that is not actually appropriate. That would otherwise defeat the purpose of the APA programme.

#### 4. Tax holiday benefit

Indian transfer pricing regulations restrict the benefit of tax holiday under Section 10A or 10AA of the I-T Act. Circular 14 of 2001 issued by the CBDT explains the rationale for such restriction and the legal provision

to implement that through Section 92C(4) of the I-T Act. The Circular states, *“The first proviso to section 92C(4) recognizes the commercial reality that even when a transfer pricing adjustment is made under that sub-section, the amount represented by the adjustment would not actually have been received in India or would have actually gone out of the country. Therefore, it has been provided that no deductions u/s 10A or 10B or under Chapter VI-A shall be allowed in respect of the amount of adjustment.”*

In APA, the taxpayers repatriate cash to India as part of the mandatory condition of APA. But that fails the basic premise for restriction under Section 92C(4), and taxpayers can



be allowed the benefit of tax holiday for transfer pricing adjustment on cash repatriation. But since there is no guidance available on that from the CBDT, tax authorities do not allow tax holiday benefit for the APA covered years even after cash repatriation under APA. It would thus be in order for the government to make suitable changes in Section 92C(4) to allow tax holiday benefit to taxpayers on cash repatriation for transfer pricing adjustment in line with the legislative intent. It needs to be recognised that when Section 92C(4) was brought in, there was no APA and also there was no cash repatriation rules for secondary adjustments. After the introduction of the new provisions, the existing rules may require revisiting.

**5. Impact of tax computation under MAT on an APA**

On the conclusion of the APA, complications often arise while computing book profits under MAT. The accounting for income from transfer pricing adjustment for past covered years, i.e., rollback years and past covered years, in the financial statements of the year in which the APA was concluded even though the taxable income for the respective past year is computed by taking the transfer pricing adjustment for the respective years. For MAT calculations, such prior year's income (included in the revenue of the company and "profit after tax" in the financial statements) would be considered a base for computation of book profits under MAT. Even

though these profits have already been included in the profits of the respective years for computation of taxable income of respective years, these profits cannot be deductible in the absence of any specific provision under Section 115 JB of the I-T Act. This results in the taxpayer paying additional tax on the current income, which also includes prior period income that has already been subject to tax. This additional tax under MAT is due to APA, and is beyond what was agreed in the APA, resulting in extra financial burden on taxpayers, thereby skewing the APA outcomes.

It can be argued that the taxpayer may be able to get the credit for the taxes paid under MAT in future years when the taxpayer would pay



taxes under the normal provision of the Act. But the fact remains that the tax payer would have to bear the burden of additional taxes today and so, the outcome of the APA brings in additional tax implications. There would also be implication of the additional tax payments on the interest payments under Sections 234B and 234C as well as under Section 220 of the I-T Act. Further, the present law also does not allow the credit of interest with MAT credit in future years. In effect, the taxpayer bears the burden of double interest cost.

These difficulties cannot be ameliorated unless the government reviews the current law and the terms and conditions of the APA. They may need to suitably amend MAT provisions to specifically provide for the exclusion of differential income/prior period income from the computation of book profits for the computation of corporate tax under MAT. This will free-up the APA and will not have any unintended tax burden arising out of MAT through cash repatriation. The CBDT could also consider waiver of consequential interest on the additional tax on differential income under Sections 234B, 234C and 220(2) of the I-T Act, as mentioned above.

#### 6. Inclusion of free-of-cost goods and services in the cost base

APA authorities have been consistently following the policy that all the costs that are integral to the business of the Indian entity should be included in the cost base of the Indian entity. This is particularly so for the captive service provider entities working on a cost-plus remuneration model. In view of this policy, any cost of goods or services or tools or any other tangible or intangible benefit that may be provided by the associated enterprises free-of-charge, is included in the cost

base of the entity to determine the service revenue of the Indian entity. Accordingly the cost base of the Indian entity is required to be revised to the extent of such costs. However, certain challenges arise in adopting such policy.

Different APA teams (there are 4 of them so far) are adopting different approaches with respect to these tools and assets. One example is that of the cost of the platform provided by the AE for performing the services. These platforms are actually not provided to the Indian entity, but only an access is given to the Indian entity to perform its services. In many cases, these platforms are virtual platforms – mirror image of the actual database. Thus, the platform can be understood to be only an environment in which the company carries out the information technology (IT) activity, and so its cost may not be required to be added in the base. The platform cannot be interpreted to be similar in nature with the tools or software that are used by the Indian entity to render support services to its AEs. Even in a third-party scenario, the service provider may not pay for the use of the platform. The service providers give their services and do not own the platform. The case of tools, which are essential for work, may be different in content.

Since there is no CBDT guidance on these, the APA outcomes vary depending on the understanding of the teams. While in some cases, there was no such inclusion in some cases, inclusion was insisted upon. Also, there is no standard methodology to determine the value of the free-of-cost software; APA teams use different values. That also is a source of uncertainty.

All these create uncertainty for taxpayers. It may be mentioned here that the IT/ITeS exports are

important and any uncertainty may adversely influence investments in the sector and also the overall businesses.

#### 7. Transparency on the comparable set used for APA proposal

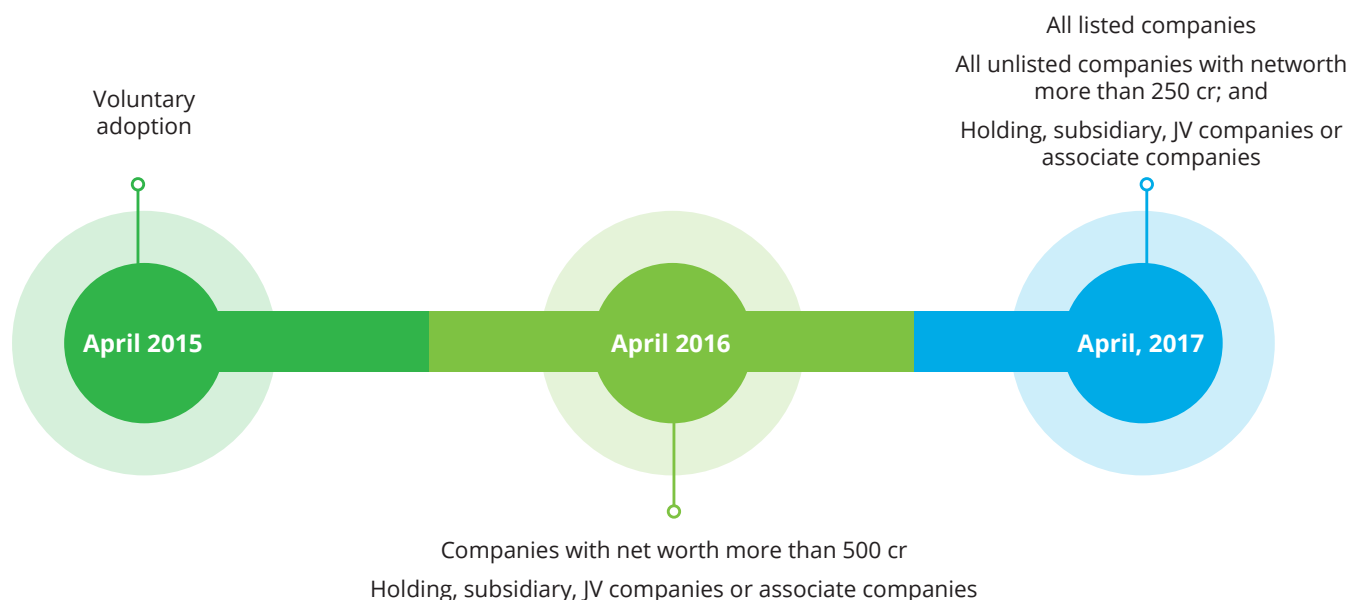
APA teams generally do not share the comparable set used while determining the ALP. This creates lack of transparency and a perception that APA authorities are using similar ALP rates for closer business activities. Perception also gains ground that APA resolution ultimately gives safe harbour rate.

Comparability analysis and benchmarking analysis is fundamental to arm's length determination. Comparability analysis could also include other factors such as market demand, labour forces, etc., in line with the OECD transfer pricing guidelines. Therefore, if the ALP were not determined based on strong comparability analysis, it would result in subjectivity, creating uncertainty for taxpayers. The CBDT should therefore provide some guidelines to the APA officers on the approach for comparability analysis and the extent of information that can be shared with the APA applicant for objective negotiations.

#### 8. IND-AS impact on APA

All the Indian companies up to March 2015 prepared financial statements under the Indian Generally Accepted Accounting Procedures (IGAAP). With effect from April 2015, India introduced India Accounting Standards (IND-AS) which were based substantially on International Financial Reporting standards (IFRS). The IND-AS was introduced in a phased manner and from April 2017, almost all companies (some exceptions are there) are mandatorily required to prepare statutory financial statements under IND-AS.

Diagram 3: Introduction of IND-AS in India



Accounting and disclosure treatment under IND-AS are materially different from the accounting treatment under IGAAP. As a result, financial statements under IND-AS are materially different from financial statements under IGAAP. Arm's length pricing of international transactions are based on financial statements. APA generally defines the methodology and the operating and non-operating items that would be considered for the computation of profit level indicators (PLI). For the APAs that have been concluded or will be concluded, the APA period including the rollback period may cover both the IGAAP period and the IND-AS period. There is a possibility that certain cost/ revenue items are accounted differently in the two financial statements and that could impact the computation of ALP agreed in the APA.

The APA generally states the critical conditions, the failure of which may result in cancellation of the APA. One of the critical conditions often stated in the APA is that the relevant financial, tax and accounting method should materially be the same. In case of the transition of

financial statements from IGAAP to IND-AS during the APA period, it may be regarded as change in the accounting method. Further, the change in accounting treatment may result in different arm's length pricing than agreed in the APA. It is therefore imperative that the APA authorities are also conversant with IND AS and its impact so that negotiation, discussion and agreement is reached at the time of conclusion of the APA instead of leaving it uncertain.

**9. Impact of GST impact on APA outcome**

Transfer pricing adjustment based on APA outcome involves cash repatriation, as per the recent amendment in the Income Tax Act. This is done through invoicing. These invoices attract indirect tax implications. GST is leviable on purchases, service cost, free of cost services from AEs, service charges from associated enterprises. Similarly, import transactions have custom valuation implications. The APA authorities need to take into account the indirect tax implications on transfer pricing adjustments. Sometimes, indirect tax becomes

an invisible cost on taxpayers. Since the APA gets concluded after about 18-24 months of filing and by that time Custom Duty would have been paid on the import of goods, refunds for the change in import price cannot be requested beyond a time as it can be asked for only up to a specified period. Also, for some reason if the import price is reduced due to APA negotiation after the specified period, the differential Custom Duty can be a sunk cost for the taxpayer. Considering the above, it is suggested that the government may specify internal guidance that the overall impact of APA outcome on both the direct and indirect taxes be considered at the time of APA negotiations.

**10. Use of CbC reports and Master file**

India has adopted 3-tier transfer pricing documentation as per the BEPS recommendation under Action 13. Indian tax authorities have access to Master File and CbC report of the MNEs. These reports of MNEs provide information, such as, their global presence, nature of business operations in different countries, allocation of global profits, information

about intangibles, etc. The Indian government has stated during BEPS discussions that it would use CbC reports for risk identification, and confidentiality of the information would be maintained. But quite often, APA authorities request the APA applicant to submit the Master File and the CbC file. While one can see the reason for such request, for the purpose of transparency, the CBDT should issue a clear guidance on the use of such reports, their confidentiality and the circumstances for furnishing of the CbC reports.

#### 11. Restriction under Section 92(3) to not apply to APA

As per Section 92(3) of the I-T Act, the taxable income of the taxpayer cannot be reduced or the losses cannot be increased due to transfer pricing adjustment. But there are circumstances in APAs, when the arm's length price agreed in the APA, could be lower than the price at which the transaction had actually taken place in the past covered years and/or the rollback years. This may result in lowering of the taxable income of the taxpayer. This would contravene the provisions of Section 92(3) of the Act.

In APAs there are also very often contrary situations - the taxable income is enhanced due to adjustment in the APA, requiring taxpayer to pay tax and also get cash from AEs for the shortfall. That creates an imbalance and extra tax burden for the taxpayers. Since APAs' conclusions take time, this situation does take place more often than not.

Given that the current law is prejudicial to APA applicants, taxpayers tend to show the

transactions at a conservative price so that the APA authorities take that as a base level to start with, and they do not get the case that the final prices are lower than that shown. This is particularly so because in APA, the arm's length price determination is for a bunch of years rather than each year separately. This results in interest on the differential tax under Sections 234B and 234C of the Act for the taxpayers.

Since the laws need to be equitable, it would be in order to have a review of the provisions so that the outcome is fair and equitable for the APA.

#### 12. Benefit of APA on past litigations

Arm's length price is determined during an APA process after a detailed review of the business operations and the FAR of the taxpayer and the AEs. Final price arrived is agreeable to both the taxpayers and the tax administration. Question often arises: whether this price can be used to settle the TP disputes if the FAR of the taxpayer remains same and the transactions are also the same. Different benches of the Income Tax Appellate Tribunals<sup>13</sup> and the High Courts<sup>14</sup> have agreed to use the APA results for the case before them. The CBDT, of late, has been restricting persuasive value of the APA, and have inserted clauses in the APA agreement that would restrict the APA outcomes. They cannot then be used to settle past litigations.

One needs to take pragmatic view on that for the overall objective of dispute management. One can understand the conflict that may be there between negotiated settlements versus strict application

of law. But since the courts, have taken a positive view, so it is expected that a positive view on the matter can certainly be in order. Besides, transfer pricing cases are tax avoidance cases and not evasion cases. There is no criminal liability arising in these cases. The outcomes are civils and so flexibility can be demonstrated by the CBDT to settle these cases, and APA does provide a good basis for that.

#### 13. Framework agreement

The Indian government entered into a framework agreement with the US in 2015 with the objective of resolving large pendency of MAP cases of IT and ITeS companies. The two countries set out several financial parameters and the cost plus margins that may be applied to each case. The framework agreement played a very positive role in resolving close to 400 MAP cases, resulting in significant reduction in the inventory of pending MAP cases. Though it would be odd to suggest that similar mechanism could also be attempted for the pending unilateral APAs for IT/ITeS case, in MAP cases, determination of total income or arm's length price has already been determined, whereas in APAs the arms' length price are yet to be arrived at. FAR of the taxpayer is not known. But one needs to keep in mind the management of 684 pending cases. A large number of those could be similar IT/ITeS cases. The government can consider devising a framework of various quantitative and qualitative parameters and the range of arm's length prices between which the negotiation can be done by the APA authorities with the taxpayers.<sup>15</sup>

<sup>13</sup>. Ranbaxy Laboratories Ltd. versus ACIT, Range -15, Delhi, ITA.196/ Del/2013. (ITAT)

<sup>14</sup>. Pr. CIT, Delhi -1 versus Ameriprise India Private Ltd., ITA/206/2016. (Delhi High Court)

<sup>15</sup>. The framework could cover qualitative criteria such as contractual arrangement with AEs, nature of services undertaken in India, technical capabilities of employees in India, direct and indirect reporting structure, and contribution of Indian entity in the DEMPE (development, enhancement, maintenance, protection, and exploitation) of the group's intangibles, etc. Quantitative criteria could include the employee strength, average salary levels, overall cost base, net worth of the company, number of years of existence, capacity utilisation, etc. Range of margins could be determined based on detailed comparability analysis.

One may argue that this would result in making APA somewhat akin to safe harbour rules. But, when we see the general outcome for similar set of APA applicants, one realises that the APA authorities in any case have some unwritten model and arm's length price. This is despite detailed FAR analysis and site visits, etc. It is thus a matter of recognising the process and outcome and being practical so that the large inventory of APA applications can be liquidated quickly. Otherwise, APA teams often invest large part of their time asking and scrutinising varied information which may or may not be relevant for the case. A comprehensive, flexible and broad framework would reduce inefficiency and increase the pace for APA resolutions.

**14. ALP determined under APA can reduce the risk of any further profit attribution in India**

Once the ALP is determined under the APA after the comprehensive review of the Indian entity and its

AEs, there may not be any scope for any further profit attribution to Indian entity on the basis of any PE constitution in India. But it is understood that the authorities have of late been trying to keep the two issues separate. As per the Indian government, APA programme is only meant for transfer pricing related issues and attribution of profits to a PE is not covered by the APA programme. The APA programme is meant for determination of FAR, and consequent ALP for the covered international transactions undertaken by the applicant. ALP is not the end to the issue of attribution of profits to a PE since there are other factors such as demand and market that are not covered in determination of ALP. India has adopted a position at an international level that it does not accept the so-called 'Authorised OECD approach' for profit attribution. India is part of an international programme that

is trying to seek consensus on this issue. India is of the view that while there is a certain importance of the functions and activities undertaken, one of the most important factors for profit attribution is the demand and market and there has to be a return attributable on the basis of where the demand for the product / service is explored. This issue is also being debated internationally in the light of the current draft paper by the OECD on profit attribution.

In view of the above, even after detailed scrutiny and agreement on the ALP, taxpayers may continue with the risk of additional profit attribution on PE in India. This can pose different questions. It will thus be in order that the CBDT set out clear principles so that the advantage of APA – an important dispute prevention instrument is used fully for the purpose it has been brought in.





### 15. Streamlining safe harbour

The government changed safe harbour rates in June 2017 and made it reasonable and to move closer to APA outcomes.<sup>16</sup> The benefit of safe harbour rules, at present, is only available to companies having low turnovers.<sup>17</sup> Certainly, small and medium companies need lower profit indicator rates than the big turnover companies given that their functions are simpler. But that may need reconsideration by policy makers. In any case, even small and medium taxpayers have been loath to adopt safe harbour rules. Updating of transfer pricing comparable set, for example, of IT and ITeS industry has often shown that the profit level indicators have moved southward from earlier margins of 18 per cent (for IT companies) and 17.5 per cent

(for ITeS companies) or thereabout, to about 15.5 per cent (for IT companies) and 10 per cent (for ITeS companies), respectively. These profit-level indicators are based on what is normally adopted by the TPOs.<sup>18</sup>

All these suggest two policy changes: (a) the safe harbour rules need to be recalibrated to mirror the present low level of comparable companies' profit level indicators, and (b) the APA level margins should be even lower to take into account fact of not charging premium for APAs. It may also be added that some of the conditions in safe harbour rules, such as the condition for applicability for receipt of intra group services appear to be impractical

thereby making it impossible for taxpayers to avail of the benefit of safe harbour rules. Considering the above, the government may once again visit the safe harbour rules and index it with changing business realities of lower profit margins in the industry. The change will also set a different benchmark for profit indicators normally adopted in the APAs. A clear message can be sent that safe harbour is for small companies, and medium and large companies can go for APAs. This will also relieve the APA programme and reduce the inventory. The APA could then involve cases with complex transactions and business models that require in-depth business and economic analysis for setting the transfer prices.

<sup>16</sup> Safe harbour margins prescribed by the earlier rules were perceived to be very high by the taxpayers. In fact, the feedback was that even after factoring in a premium for tax certainty and ease of compliance, on the balance of things, the safe harbour scheme was still commercially unfeasible. For example, rates for low-end IT/IT enabled services in the earlier rules ranged from 20 per cent to 22 per cent. For contract R&D services, the rates were even higher ranging from 29 per cent to 30 per cent. In comparison, the average APA margins for these activities were around 16-17 per cent for IT/ IT enabled services and for contract R&D services, the rates were around 22-23 per cent.

<sup>17</sup> For IT and IT enabled services, the revised rules have lowered the margins to 17-18 per cent. Earlier the rates were 20-22 per cent. The new transaction eligibility quantum are also lower, at INR 1000 million and less, and between INR 1000 and INR 2000 million. This clearly indicates that the new rules are meant for smaller taxpayers. Larger taxpayers have been kept out of this safety net.

<sup>18</sup> In comparison, those normally adopted by the taxpayers are lower by much lower.



# Summary of proposals and suggestions

While achieving tax certainty is a key objective of the APA, it is also important that the overall cost of tax compliance is reduced. Introducing flexibility in developing practical approaches for complex transfer pricing issues would be the hallmark of the APA programme. Since APA renewals are starting, it would be in order to make sure that time and efforts expended during negotiating the original APA are properly leveraged. Changes as suggested above under the three rubrics - procedural aspects, post-APA compliance and legal and schematic aspects - would provide guidance for taking the APA programme to the next level of being taxpayer-friendly, of robustness in the regime and for achieving the desired standards of advanced tax administrations.

For the benefit of the readers and the tax policy makers, we summarise below our suggestions mentioned above:

## a) Procedural aspects –

- Adopt e-filing for APA applications, submission and all other documentation, in line with system changes taking place for tax return filing and appeals.
- Augment resources in the APA teams. Officers should be given sufficient fixed tenure so that their experience can be suitably used. Teams should also have some subject matter experts.
- APA manual should be compiled giving the best practices so that APA teams can leverage on them. If possible, that manual should be made public too.
- Adopt measures to reduce unnecessary delays in APA conclusions. Delays can be from both sides – taxpayers' side as well as from tax administration side.
- Detailed practice and procedure should be outlines for APA renewal cases. If possible, a separate team should be set up to fast track them.

## b) Post-APA compliance procedures

- Post-APA compliance procedures should be streamlines so that duplication can be avoided.
- Guidance should be issued to the TPOs on the objective for review of post-compliance of APA cases.

## c) Legal and other aspects

- Taxpayers find the present rule on cash repatriations harsh and impractical, since those cases are of yesteryears. Alternate mechanism for cash repatriation should therefore be brought in, which is practical and less burdensome.
- APA programme should not be very restrictive on business restructuring considering the dynamic nature of the businesses.
- It should be the endeavour of the APA officers to use more commercially and justifiable TP method. Otherwise, it defeats the very purpose of the APA programme.
- Present ambiguity in allowing tax holiday benefit on the transfer pricing adjustment in case of cash repatriation under secondary adjustment rules would need clarification.
- APA conclusions often result in double tax impact on MAT computation. MAT provisions may need a relook to avoid such double taxation effects.
- A consistent approach on free-of-cost goods and services is required. This otherwise may affect IT/ITeS exports.
- APA teams could be asked to share the comparable set used by them for the APA outcomes. This will bring transparency in the procedures.
- GST impact is often a hidden tax impact. Since the taxpayer needs to pay both taxes, so the overall tax impact, covering

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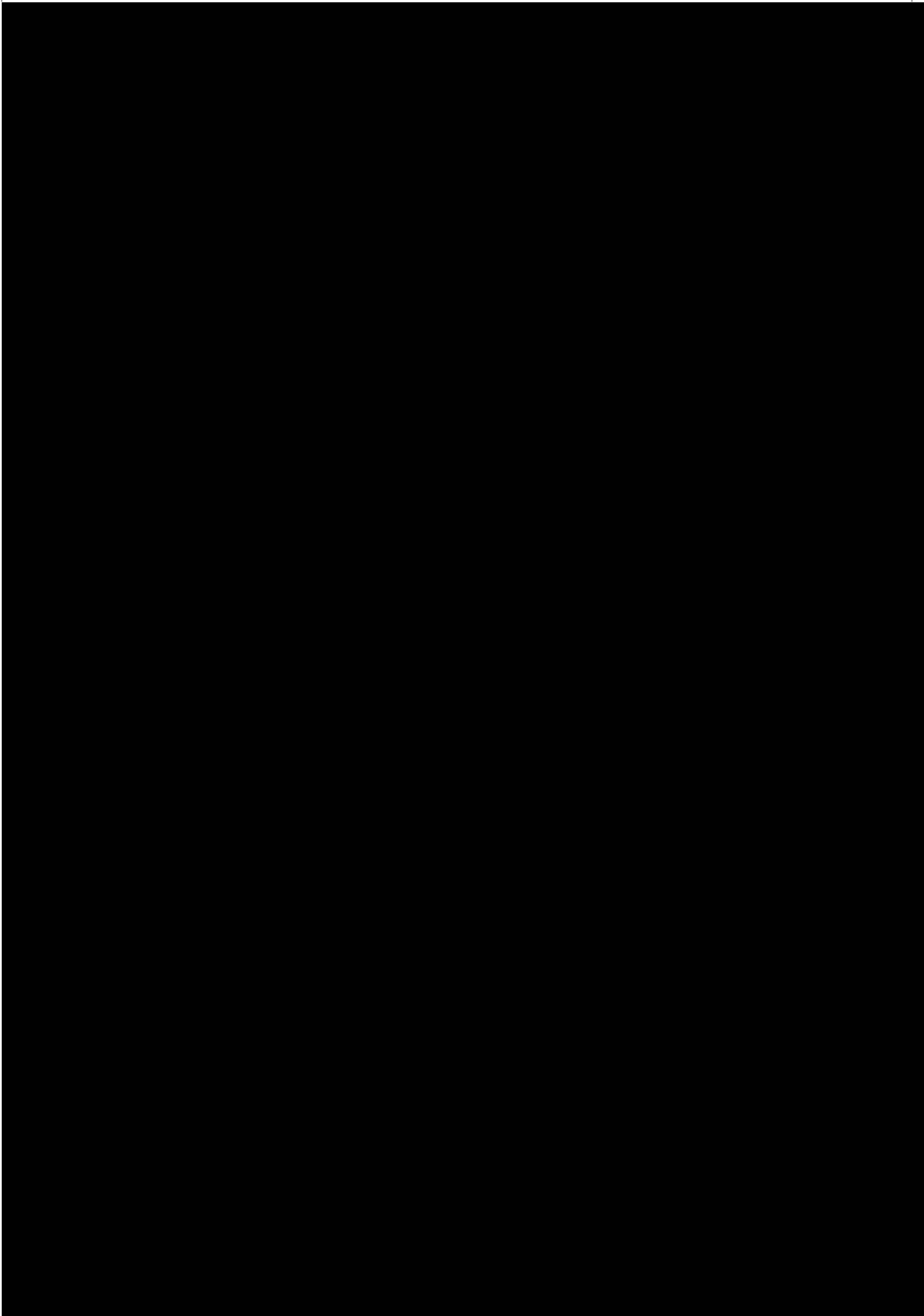
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