21 June 2017

Global Tax Alert

News from Transfer Pricing

India Tax Authority issues rules for implementing secondary transfer pricing adjustment provision

EY Global Tax Alert Library

Access both online and pdf versions of all EY Global Tax Alerts.

Copy into your web browser:

www.ey.com/taxalerts

Executive summary

India's Finance Act, 2017 (FA 2017) introduced "secondary transfer pricing (TP) adjustment" provisions in the Indian Tax Law (ITL) to ensure that profit allocation between the associated enterprises (AEs) is consistent with the primary TP adjustment. Primary TP adjustment is defined to mean determination of the transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the taxpayer. The secondary adjustment is required where a "primary adjustment" to the transfer price: (a) has been made voluntarily by the taxpayer in the tax return; (b) made by the tax officer and has been accepted by the taxpayer; or (c) is determined pursuant to an Advance Pricing Agreement (APA), safe harbor or Mutual Agreement Procedure (MAP).

Under the secondary adjustment provision, if the primary adjustment is not repatriated to India within a prescribed time, the amount not repatriated would be deemed to be an advance made by the taxpayer to such AE and interest would be charged on the advance in the manner prescribed. The Central Board of Direct Taxes (CBDT), the apex Indian Tax Administration, through a notification dated 15 June 2017, has issued rules to support the implementation of the provision by prescribing the time limit for repatriation and the method of computing the interest. While generally providing a 90-day time limit for repatriation, the rules require charging an annual interest beyond

Building a better working world

the prescribed period until the advance is settled. The notification also clarifies that the secondary TP adjustment provision is applicable from the Financial Year (FY) 2016-17 onwards and would apply only where the quantum of primary TP adjustment is in excess of INR10 million (approx. US$154,000).

Detailed discussion

Background

The FA 2017 introduced some significant changes to the ITL with the objective of strengthening the anti-abuse measures as well as to align the ITL with international practices. One of the changes included the introduction of secondary adjustments in the TP regulations.

The secondary adjustment rules are an internationally recognized approach and already part of the TP regulations in many leading economies. The Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Corporations and Tax Administrations (OECD Guidelines) define the term secondary adjustments as "an adjustment that arises from imposing tax on a secondary transaction." A secondary transaction is further defined as "a constructive transaction that some countries will assert under their domestic legislation after having proposed a primary adjustment in order to make the actual allocation of profits consistent with the primary adjustment." Secondary adjustments may take the form of constructive dividends, constructive equity contributions or constructive/deemed loans.

While the approaches to secondary adjustments by individual countries vary, they represent an internationally recognized method to realign the economic benefit of the transaction with the arm's length position, and seek to restore the financial situation of the relevant connected parties to an arm's length scenario.

Seeking to align Indian TP regulations with OECD Guidelines and international practices, FA 2017 introduced the "secondary adjustment" provision in the ITL.

Meaning of primary adjustment and secondary adjustment

- Primary adjustment is defined to mean determination of the transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the taxpayer.
- Secondary adjustment has been defined to mean an adjustment in the books of accounts of the taxpayer and its AE to reflect the actual allocation of profits between the taxpayer and its AE consistent with the transfer price determined as a result of primary adjustment.

Applicability of secondary adjustment

The provisions, as introduced by the FA 2017, are applicable in cases where the primary TP adjustment to the transfer price is:

- Made voluntarily by the taxpayer in its income-tax return
- Made by the tax officer or the appellate authority and accepted by the taxpayer
- Determined by an APA entered into by the taxpayer with the Indian Tax Administration
- Made as per the safe harbor rules framed under the ITL

Or

- Resulted from the resolution of an audit adjustment by way of the MAP under a double taxation avoidance agreement (tax treaty)

The secondary adjustment provisions required that, where as a result of a primary adjustment to the transfer price, there is an increase in the total income or reduction in the loss of the taxpayer, the "excess money" (i.e., the difference between the arm's length price determined in the primary adjustment and the price at which the international transaction was actually undertaken) which is available with its AE, needs to be repatriated into India within the prescribed time. In the case of non-compliance, such excess money shall be deemed to be an advance made by the taxpayer to such AE. Further, interest on such advance shall be computed as the income of the taxpayer in the prescribed manner. While the notification does not explicitly mention that the "excess money" should be accounted for in the books of account of the taxpayer, it can be perceived that the intent of the law is to ensure that there is no imbalance between the arm's length price determined and the price declared in the books of account.

The CBDT has now issued rules in this regard to support the implementation of the secondary adjustment provision by prescribing the time limit for the repatriation of "excess money" and the method of computing the interest.

Time limit for repatriation and applicable interest rate for delayed receipts

<table>
<tr><th rowspan="2">Type of primary adjustment</th><th rowspan="2">Time limit for repatriation</th><th colspan="2">Applicable interest rate for delayed receipts</th></tr>
<tr><th>Transaction in Indian Rupee</th><th>Transaction in Foreign Currency</th></tr>
<tr><td>Adjustment made by the Indian Tax Authority and accepted by the taxpayer</td><td>On or before 90 days from the date of relevant order</td><td rowspan="3">One year marginal cost of fund lending rate of State Bank of India as of 1 April of the relevant FY plus 325 basis points</td><td rowspan="3">Six month London Interbank Offered rate as of 30 September of the relevant FY plus 300 basis points</td></tr>
<tr><td>Suo-moto adjustment by the taxpayer</td><td rowspan="2">On or before 90 days from the due date of filing return of income</td></tr>
<tr><td>Adjustment pursuant to APA, Safe Harbor or MAP</td></tr>
</table>

If the "excess money" is not repatriated within the prescribed time limit, the interest shall be computed at the rate as prescribed above, on an annual basis, until the "excess money" is repatriated.

Year of applicability

The provision as enacted by the FA 2017 was ambiguous on the year of application of secondary adjustment in light of the fact that the provision required satisfaction of two conditions which seemed to be "cumulative" viz.: (i) primary adjustment is less than INR10 million; and (ii) primary adjustment is for FY 2015-16 and earlier years. Thus the literal interpretation of this proviso would have led to wider and unintended ramifications, including application of secondary adjustments for any previous years so long as the primary adjustment is in excess of INR10 million. Further, any amount of primary adjustment (less than INR10 million) in relation to FYs 2016-17 onwards, would trigger a secondary adjustment risk.

However, this notification clarifies that the secondary TP adjustment provision is applicable for FY 2016-17 onwards and would apply only where the quantum of primary TP adjustment is in excess of INR10 million.

Implications

When a TP adjustment is made to one member of a group (primary adjustment), it may give rise to a number of collateral consequences which may include correlative allocations, conforming adjustments and set-offs, on which no guidance existed in the ITL. By introducing the concept of secondary adjustment in the ITL and prescribing the rules for implementation, the ITL now requires appropriate adjustments to be made to conform a taxpayer's accounts so they reflect the primary adjustment, followed by repatriation of the funds into India within a prescribed time or alternatively, treat the same as an interest-bearing advance and charge interest at the prescribed rates on an annual basis. While the stated objective of the provision is to align Indian TP regulations with international practices, the provision could trigger additional income tax consequences, including the risk of double taxation. Taxpayers who are likely to be subject to a primary TP adjustment should therefore review the impact of this provision on their TP positions in India as well as in the other country and proactively consider measures such as MAP, APAs for managing TP controversy.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (India), National Tax Leader, Mumbai

- Sudhir Kapadia +91 22 6192 0900 sudhir.kapadia@in.ey.com

Ernst & Young LLP (India), National International Tax Services Leader, Hyderabad

- Jayesh Sanghvi +91 40 6736 2078 jayesh.sanghvi@in.ey.com

Ernst & Young LLP (India), National Transfer Pricing Leader, New Delhi

- Vijay Iyer +91 11 6623 3240 vijay.iyer@in.ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Transfer Pricing Group

EYG no. 03778-171Gbl

1508-1600216 NY
ED None

ey.com