

IFA Conference on International Tax - MLI / BEPS

**Provisions relating to Secondary
Adjustments (Section 92CE)**

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Contents

1

Background

2

Concept of SA Internationally

3

SA prior to FA 2017

4

SA post FA 2017

5

Rule 10CB

6

Issues and Potential concerns

7

International experience



Background



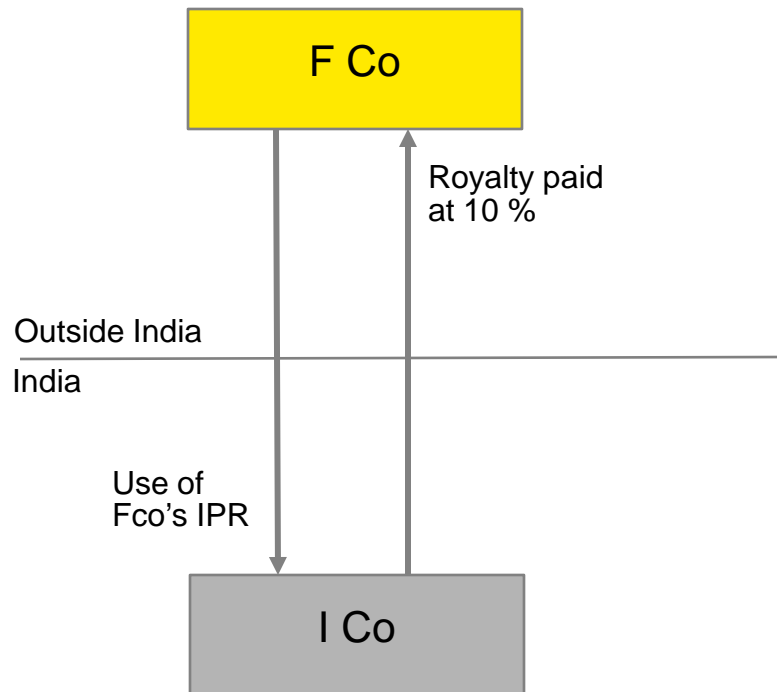
Background

- ▶ TP provisions require transactions between associated enterprises (AEs) to be undertaken at ALP
 - ▶ Adjustment is made to taxable income to the extent of difference between transfer price and ALP (Primary adjustment or PA)
- ▶ Primary adjustment under TP is effective only for tax purposes.
 - ▶ Cash benefit from the non ALP transaction can still be accumulated by parties despite PA
- ▶ Secondary adjustment (SA) introduced by FA 2017 w.e.f 1.4.18 targets the cash benefit and aims to reverse it
 - ▶ Aligns the economic benefit from a transaction with ALP
 - ▶ This is done by way of requiring repatriation of the excess cash arising on non ALP pricing
- ▶ SA provisions are contained in S. 92CE of ITA

Concept of SA internationally

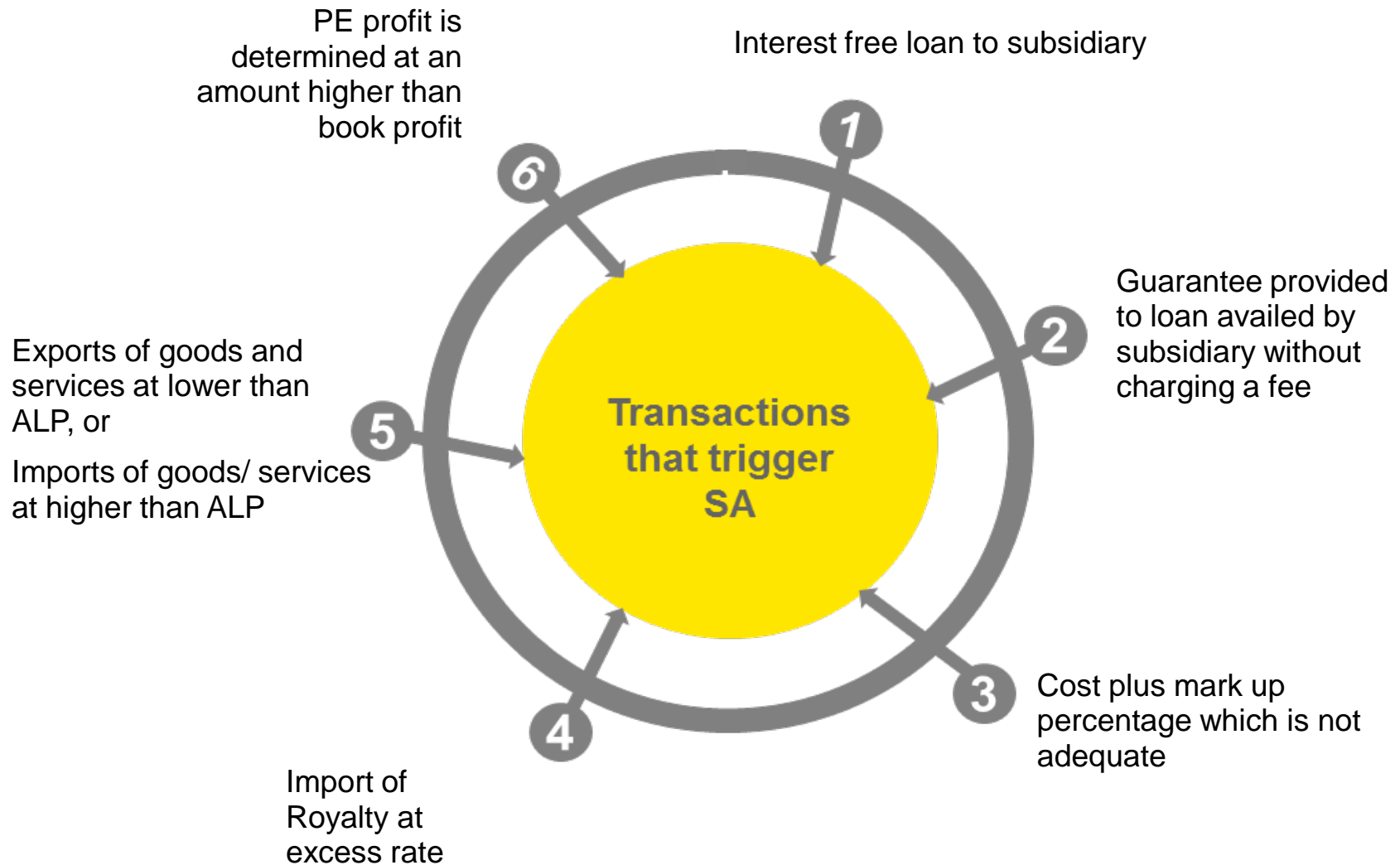


Concept of SA



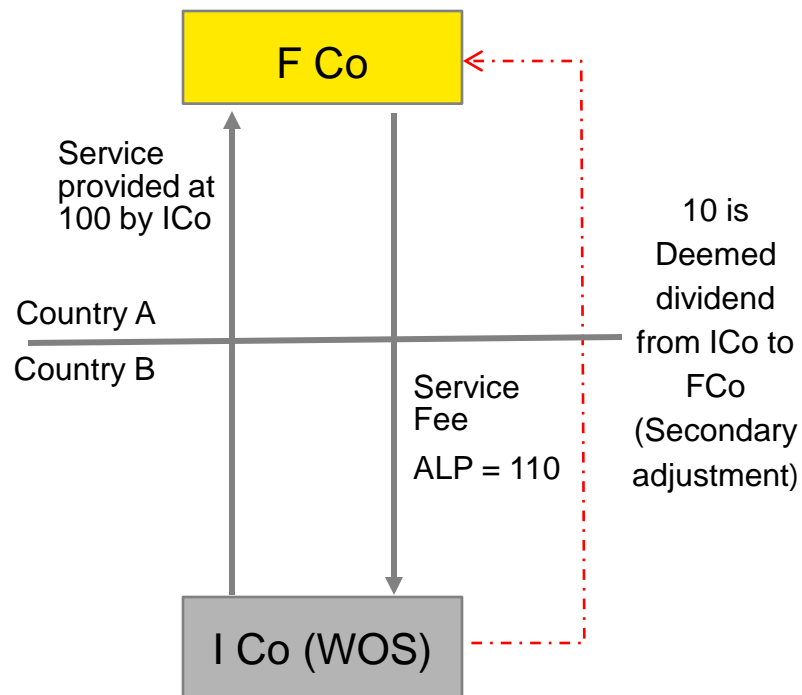
- ▶ Royalty paid to FCo @ 10%
- ▶ ALP rate of royalty = 5%
- ▶ Primary adjustment = 500
- ▶ Excess cash (short recovery) of INR 500 remains with FCo
- ▶ The difference of INR 500 is subjected to secondary adjustment
- ▶ But for secondary adjustment
 - ▶ ICo does not pay MAT on 500
 - ▶ ICo shall be neutral if royalty relates to tax exempt income
 - ▶ No DDT on such excess

Transactions that trigger SA

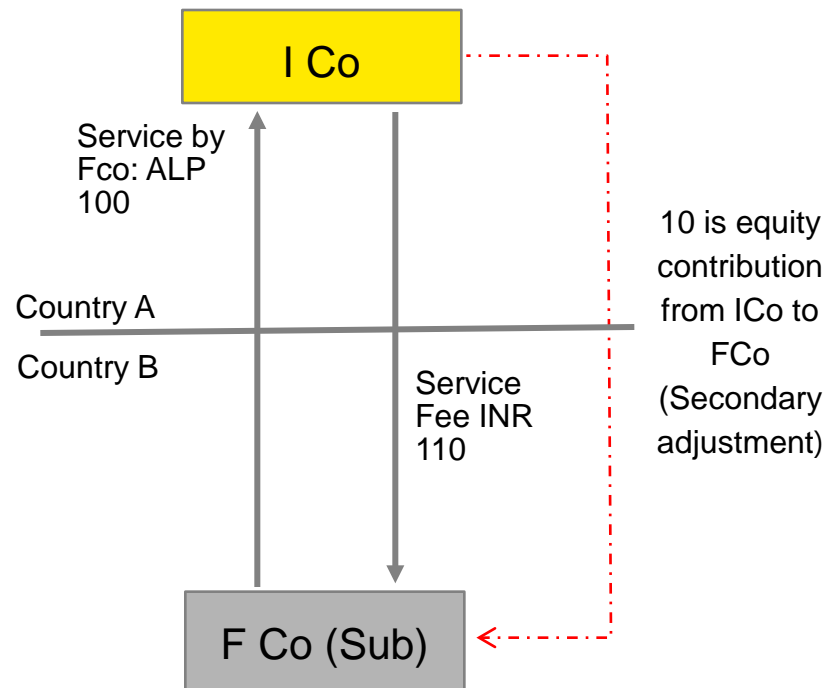


Alternative of secondary adjustment internationally

► Constructive dividend

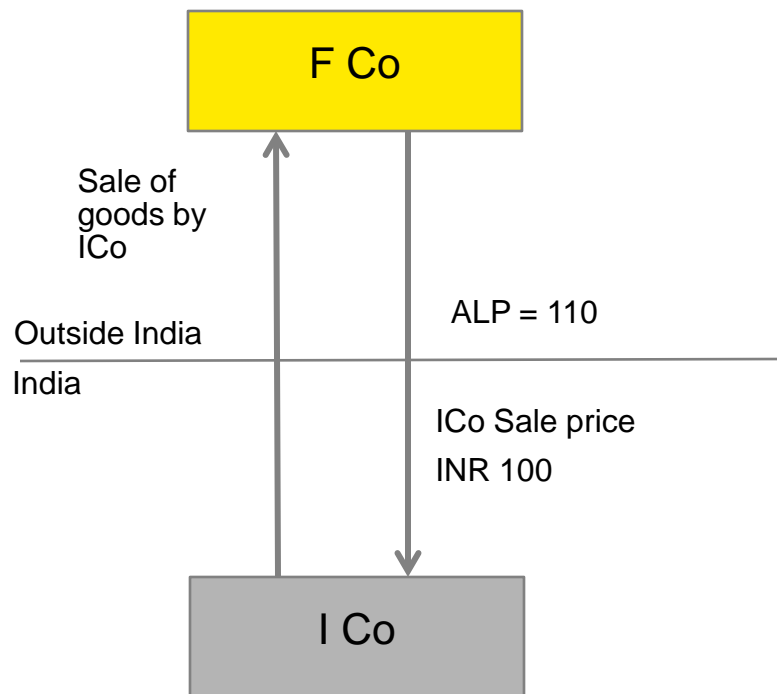


► Constructive capital contribution



In Canada and Korea, SA in nature of deemed dividend is attracted regardless of whether the AE has an ownership interest in the taxpayer (i.e. regardless of whether the foreign AE is a shareholder or not). However, in case foreign AE is a subsidiary, the difference is treated as additional capital contribution

SA in the form of constructive loan in India



- ▶ Transaction price = INR 100
- ▶ ALP = 110
- ▶ PA = 10
- ▶ Taxable income of ICo = 110
- ▶ Excess cash of INR 10 remains with FCo
- ▶ The difference of INR 10 if not repatriated to India within prescribed time is deemed as “advance”
- ▶ Interest is levied on INR 10 at prescribed rates

SA provisions are contained in S. 92CE of the Act

Issues – Variants of Secondary adjustments Internationally

Constructive Dividend and Equity Contribution methods

Advantages

- ▶ Being one off adjustment, requires minimal ongoing monitoring and administration
- ▶ Appropriate when there is direct relationship between parent and subsidiary

Disadvantages

- ▶ Dividend considered in favour of head parent. May not be appropriate when the relationship between parties is not that of a parent and subsidiary
- ▶ Equity contribution in favour of subsidiary; benefit may be to sub-subsidiary or partial subsidiary

Issues – Variants of Secondary adjustments Internationally

Constructive Loans

Advantages

- ▶ It is appropriate irrespective of the relationship (direct or indirect) between the parties

Disadvantages

- ▶ Requires regular administration as it is not one time adjustment
- ▶ Additional rules for determining period of repatriation and computation of interest
- ▶ Multiple transactions may make computation of interest tedious
- ▶ Issues may arise on deductibility of interest, etc.
- ▶ Exchange control regulations may restrict repatriation of excess funds

SA under the Act



SA prior to FA 2017

- ▶ Secondary adjustment was attempted by tax authorities in past along with re-characterization
 - ▶ For instance short receipt of share premium sought to be treated as loan and interest levied thereon
 - ▶ Ex: Vodafone India Services [TS-308-HC-2014(BOM)-TP] and Shell India Market Ltd [(269 ITR 516)]
- ▶ ALP agreed under APA enhanced by a component of dividend tax in case ALP is > book result (Eg: Cost plus entities)
 - ▶ Assumption is that if such excess funds were repatriated in normal course, it would have resulted in DDT. Bottleneck, unless APA modified!
- ▶ Under MAP there are instances of requirement of repatriation of funds to the extent of ALP adjustment

SA under the Act post FA 2017



SA under the Act post FA 2017

[W.e.f. A.Y. 2018-19]

- ▶ S.92CE Requires corresponding adjustment to be made in the books of Taxpayer and AE in case of a PA so as to avoid mismatch in cash account and actual profit
 - ▶ Entry in the books impacts MAT liability in the year in which entry is made
 - ▶ Concerns of FEMA compliance
- ▶ Mandates repatriation within prescribed time if excess cash remaining outside India due to PA
 - ▶ Rule 10CB to prescribe time period for funds repatriation
- ▶ Excess money if not repatriated within prescribed time, deemed to be an “advance” granted by Taxpayer to AE
 - ▶ Interest on such advances calculated at rates prescribed in Rule 10CB is taxed in the hands of Taxpayer

Conditions for applicability of S. 92CE

- ▶ Proviso to S. 92CE provides for following exclusions from applicability of SA
 - ▶ IF PA pertains to FY preceding FY 16-17
 - ▶ PA is below INR 1 crore in a FY
- ▶ Are the two conditions cumulative or to be seen independently?
 - ▶ Explanatory notes (CBDT circular on FA 2017) to FA 2017 indicates cumulative reading of the twin condition

Particulars			
AY	FY 15-16	FY 16-17	FY 16-17
PA	1.1Cr	0.9Cr	1.1 Cr
SA	No	No	Yes

- ▶ The threshold of 1 crore is to be seen for aggregate of PAs in a FY

SA under the Act post FA 2017

- ▶ PA in following scenarios is covered by S. 92CE
 - ▶ Suo moto adjustment in Return of Income (“ROI”)
 - ▶ Addition by AO accepted by taxpayer
 - ▶ Determination in Advance Pricing Agreement (“APA”)
 - ▶ Determination pursuant to safe harbour rules
 - ▶ Resolution under the Mutual Agreement Procedure (“MAP”)

Transactions which will trigger SA in India

- ▶ Interest free loan granted by I Co to foreign subsidiary
- ▶ Guarantee provided by I Co to foreign subsidiary
- ▶ Exports of goods and services at lower than ALP, or
- ▶ Imports of goods/ services at higher than ALP
- ▶ Indian PE profit is determined at an amount higher than book profit
- ▶ Higher royalty paid to Foreign affiliates

All the above transactions result in funds retained by overseas enterprise at the sacrifice of an Indian enterprise.

Transactions which will trigger SA in India

- ▶ Notional taxation in the hands of FCo for interest free loan to AE in India
- ▶ Notional taxation in the hands of FCo for royalty free use of IP granted to AE in India
- ▶ Dealings between two PEs of FCo in India
- ▶ Services rendered by FCo to Indian AE at a price which is lesser than the ALP
- ▶ PE of F Co has reported income > ALP

Rule 10CB relating to SA



Rule 10CB – Time for repatriation

- ▶ Rule 10CB has been prescribed u/s 92CE
- ▶ Time limit for repatriating excess funds to India is as follows:

Type of primary adjustment	Time prescribed under rule 10CB	Remarks
Voluntary TP adjustment	90 days from due date of filing of return under section 139(1) of the Act	Due date u/s 139(1) refers to due date of original return and not return filed u/s 139(4)/139(5)
Primary adjustment pursuant to safe harbour provisions		Due date u/s 139(1) refers to due date of original return and not return filed u/s 139(1)/139(5)
Primary adjustment pursuant to APA u/s 92CD		Arguably scheme of APA and intent would require computation of 90 days from the date of modified return filed u/s 92CD
PA pursuant to MAP		MAP itself may indicate a time period for repatriation and may hence override Rule 10CB
PA due to adjustment made by AO accepted by the tax payer	90 days from date of the order of Assessing Officer or the appellate authority, as the case may	-

Rule 10CB – Interest rates

- ▶ Rule 10CB(2) prescribes the following rates at which interest is to be levied on failure to repatriate excess funds with time specified in Rule 10CB(1)

Transaction currency	Interest rate
Indian currency	One year marginal cost of fund lending rate of State Bank of India as of 1st of April of the relevant FY plus 325 basis points
Foreign currency	Six month London Interbank Offered rate as of 30th September of the relevant FY plus 300 basis points.

- ▶ Relevant FY for the purpose of Rule 10CB(2) would be the year for which interest is to be computed.

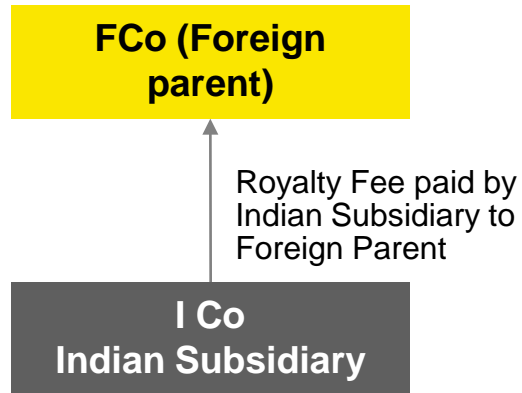
Interest levy clocks in from which date?

- ▶ Rule 10CB prescribes 90 day period for repatriation
- ▶ In case of failure to repatriate interest to be computed from which date?
- ▶ Interest to be computed post expiry of the 90 day period or from the first day itself?
- ▶ Following supports that interest to be computed post expiry of 90 days
 - ▶ S. 92CE seeks to recover interest which parties in a commercial relation are expected to recover
 - ▶ Rule 10CB allows a period of 90 days to make good the default
 - ▶ 92CE read with Rule 10CB would indicate that upto expiry of 90 days there is no advance
 - ▶ No indication in 92CE to deem it as an advance from the beginning
 - ▶ Interest u/s 10CB is to be computed for future period, it is not deemed to be imputed even for the past period

Issues and potential concerns



Potential double taxation due to SA



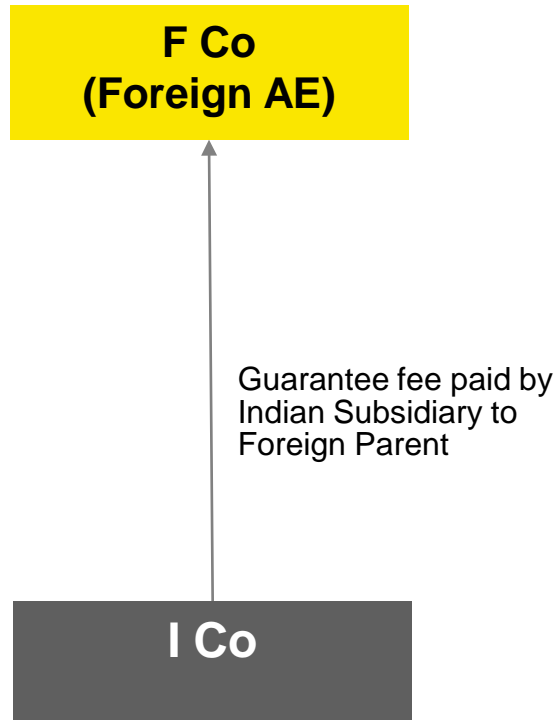
Transaction background

- ▶ Royalty fee paid by I Co is INR100 (Royalty paid @ 5%)
- ▶ Arm's length royalty fee determined in unilateral APA is INR70 (Royalty rate is 3.5%)
- ▶ Excess amount of INR 30 lying with F Co
- ▶ F Co has to repatriate INR 30 to I Co
- ▶ If repatriated – No secondary adjustment
- ▶ If not repatriated – INR 30 to be treated as advances in books of I Co

Leads to double taxation

- ▶ Withholding tax has been collected on the initial royalty payment @ 5%
- ▶ No downward adjustment for FCo's taxable income in India
- ▶ Whole amount of INR 100 will be taxable in FCo jurisdiction (unless relieved under bilateral APA/MAP)
- ▶ Even if advance is repatriated back there is no mechanism for setting off withholding tax.
- ▶ In addition interest will be charged on excess money for the period it remains outside India
- ▶ MAT liability on ICo on book adjustment
- ▶ Charge of DDT when the amount is repatriated back
 - ▶ Non availability of tax credit in the home jurisdiction

Deemed dividend implications



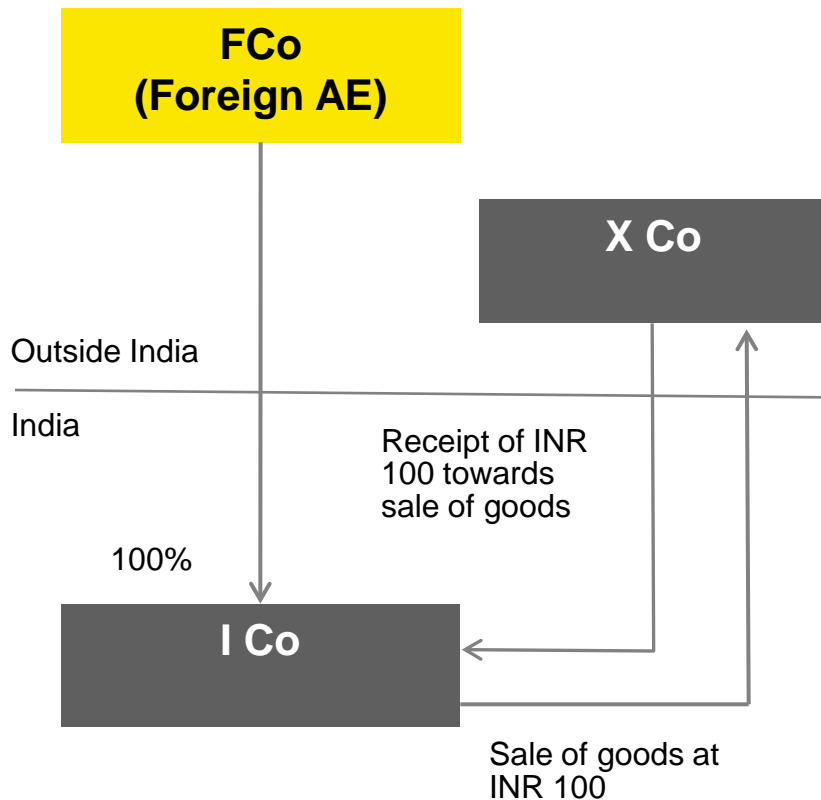
▶ Facts

- ▶ Guarantee Fee paid by I Co is INR 100
- ▶ Arm's Length Guarantee fee determined in unilateral APA is INR 50
- ▶ Excess Amount of INR 50 lying with F Co
- ▶ F Co has to repatriate INR 50 to I Co

▶ Issue

- ▶ In case where foreign AE is a parent and excess money is treated as advance in the books, will it trigger deemed dividend (now, DDT) implications u/s 2(22)(e)?
- ▶ Absent GAAR, strict condition of physical payment !

92CE applicability to 92B(2) transaction



- ▶ ICo sells certain products to X Co at INR 100
- ▶ X Co and ICo are not AEs
- ▶ The terms of sale in substance are determined by FCo
- ▶ Sale transaction is a deemed international transaction
- ▶ S. 92CE aims at recovery of funds with AE
- ▶ Borrows definition of AE in s.92A

Whether S. 92CE applies to transaction between HO and PE?

- ▶ **View 1: HO and PE are same assesses, S. 92CE does not apply**
 - ▶ 92CE refers to PA for the assessee, PE is not a separate assessee
 - ▶ Limit of INR 1 Cr also indicates applicability qua assessee
 - ▶ PE is at best an enterprise but not a separate person except for the fiction of Explanation to S. 9(1)(v)
 - ▶ Definition of “enterprise” in s.92F not applied to S.92CE
 - ▶ There can be no loan unless there are two distinct persons.
- ▶ **View 2: 92CE applies to the transactions between HO and PE**
 - ▶ Implicit in the definition of AE is the expression “enterprise” which includes PE
 - ▶ 92CE does not even refer to definition of international transaction defined in S. 92CB. Holistically, PA in respect of ALP can occur only in case of IT
 - ▶ SA is merely an extension of PA. Once TP provisions apply to trigger PA, SA follows
 - ▶ PA is always in name of assessee. Hence, the reference to “assessee”
 - ▶ Intent is to bring economic resources to India

Even if view 2 is preferred can there be any adverse implications if PA < HO credit balance?

Miscellanea

- ▶ S. 92CE(1)(a) provides for SA in case where PA is because of adjustment by AO and accepted by the Taxpayer
 - ▶ When can Taxpayer be considered to have given his acceptance?
- ▶ Whether penal provisions will be attracted for failure to make book adjustment by ICo or by AE FCo?
- ▶ Where there is impossibility of recovery say due to regulatory restriction in FCo jurisdiction, will real income theory come to the rescue of the Taxpayer?
- ▶ Is repatriation relieved where the recovery of excess money has been waived by ICo by recording bad debts?

International experience



International experience

Country	Threshold limit	Characterization of excess profit	SA not to apply if funds are repatriated
Canada	NA	Dividend	Yes
France	NA	Dividend	Yes
Korea	NA	Dividend or capital contribution,	Yes
South Africa	NA	Deemed dividend/donation	Yes
UK	Primary adjustment to be in excess of £1 million	Deemed loan	Yes
United States	NA	Dividend or a capital contribution	Yes
Netherlands	NA	Dividend or deemed capital contribution	Not known
Spain	NA	Dividend or deemed capital contribution	Not known

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Thank You!

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