Demystifying Secondary Adjustments

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Introduction

One of the significant developments in the arena of Transfer Pricing law in India, is the introduction of the concept of Secondary Adjustments into vide the Finance Bill 2017. Already wide ranging discussions and deliberations are going on over introduction of this concept, which aims at aligning the country's transfer pricing provisions with OECD transfer pricing guidelines, and there are views that carrying out secondary adjustments would heavily tell upon the tax liability and cash flows of Multi-National Enterprises (MNEs). This article is an attempt to demystify the concept of secondary adjustments.

Secondary adjustments in Transfer Pricing as is prevalent globally

The concept of secondary adjustments is an internationally recognized approach aimed at aligning the economic benefit with the arm's length position. This concept has found its way into the domestic laws of countries like Canada, South Korea, South Africa and certain other European Countries like Austria, Bulgaria, Denmark, Germany, France, Luxemburg.

The OECD defines a secondary adjustment as an "adjustment that arises from imposing tax on a secondary transaction in transfer pricing cases" where a secondary transaction is 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". Here, what OECD guidelines advocate is actual allocation of profits consistent with the primary transfer pricing adjustments, which, can be achieved by, the country having proposed the TP adjustment, asserting under their domestic laws, a constructive transaction whereby excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly. Such secondary transactions could take the form of either constructive dividends, constructive equity contributions, or constructive loans.

To drive home the concept of secondary adjustment, given below is a simple example:

Particulars	Amount (in Rs crores)
Sale of machinery by A Co. to its AE, B Co in another country	1.4
Arm's Length Price (B)	2.5
Upward adjustment in the hands of A co. **(C = B - A)**	**1.1**

In the above example, the upward adjustment carried out in the hands of A co. is called the **Primary Adjustment.** However, such a primary adjustment alone would only increase the taxable income of the taxpayer i.e. A Co. but the issue of remittance of the excess funds i.e. difference between the

transaction price and the arm's length price, with B Co. would not get addressed. This would result in the AE retaining the differential funds, thereby defeating the very objective of the TP provisions which aims at ensuring correct allocation of taxable profits among tax jurisdictions. This defect can be resolved by effecting a **Secondary transaction** in the books of accounts of the taxpayer i.e. A Co. by accounting for such excess of funds with the AE as a deemed receivable and accordingly imputing an arm's length interest on the same which is called a **Secondary Adjustment**.

Given this, it is also pertinent to note that, any country proposing to carry out a secondary adjustment has to ensure that its domestic laws provide for such adjustments, existence of a legislative mandate under the domestic laws thereby becoming indispensable.

Introduction of the concept of Secondary adjustments into India's domestic laws

In the recent past, many companies in India transacting with their AEs outside India have been subject to the rigors of "Secondary adjustments" by the TP authorities. The courts however, have also time and again struck down these adjustments for lack of express mandate under the domestic laws of India, providing for such adjustments.

India, in order to align its transfer pricing provisions with the OECD TP Guidelines and international best practices and of course, put to rest the litigation around validity of carrying out secondary adjustments across various appellate fora, has thought it appropriate to introduce the concept of secondary adjustment into its domestic tax laws by proposing to insert Section 92CE into the Income-tax, Act 1961 ("Act") whereby the taxpayer will be required to carry out secondary adjustments where the primary adjustments to transfer price have been made, in any of the following manner :

- By the taxpayer suo motu in his return of income;
- By the Assessing officer and accepted by the taxpayer;
- Determined by an Advance Pricing Agreement (APA) entered into by the taxpayer;
- Determined as per the safe harbour rules framed; or
- Arising as a result of resolution of an assessment by way of Mutual Agreement Procedure ("MAP")

Secondary adjustment is defined to mean an adjustment in the books of accounts of the taxpayer and its AE to reflect that the total allocation of profits between the taxpayer and its AE are consistent with the transfer price determined as a result of the primary adjustment, thereby removing the imbalance between cash account and actual profit of the taxpayer.

Accordingly, the proposed section contemplates recharacterization of a primary TP adjustment (resulting either in an increase in income or a reduction of profits of the taxpayer), as an advance made available by the taxpayer to its AE. Such primary adjustment, in other words, partakes the character of excess money available with the AE, which, if not repatriated into India within a certain prescribed time limit, shall entail an interest being imputed on such advance and accordingly getting taxed. The act of imputing such an interest on advance is called the Secondary Adjustment.

However, the applicability of secondary adjustments is proposed to be restricted to only primary adjustments made in excess of Rs 1 crore and will be applicable in relation to AY 2018-19 and subsequent years only.

Impact of introduction of this concept

On a strict reading of the provisions of the proposed section what is derivable is that secondary adjustments are applicable only on undisputed primary adjustments which have been accepted by the taxpayer or have been declared as final under certain procedures prescribed and available under the Act. Therefore, primary adjustments which are a subject matter of appeal will not call for any secondary adjustments on the part of the taxpayer.

Secondly, the mandate of deeming a primary adjustment made in the hands of a taxpayer, as an advance, may have an effect, not only for the year to which a primary adjustment relates but also in the subsequent years, until such time the loan is considered to be repaid. This may in turn have a severe impact on the taxpayer, in the event the prescribed time limit for repatriation expires prior to repayment of the deemed advance by the AE, resulting in, the interest imputation becoming a perennial affair. Presently, there are no rules laid down for determining the prescribed time limit. Therefore, a little thought on this aspect before coming out with the rules would spare the taxpayers of this ordeal.

On the flip side, it may be interesting to note that India has chosen to restrict the deeming fiction adopted, only to the extent of treating the primary adjustment as an advance from the taxpayer to the AE as against certain other treatments discussed in the OECD TP guidelines like constructive dividends, constructive equity contributions etc. Had the government included treatments in the nature of dividend under the scope of secondary adjustments, it would have had to grapple with the challenges of a possible double taxation. How would a double taxation in this context arise? For example, where a secondary adjustment takes the form of a constructive dividend, any tax which has been imposed, may not be relievable even under the concept of underlying credit, as there may not be a deemed receipt under the domestic legislation of the other country. However, such double taxation could be overcome by possibly giving a credit or some other form of relief by the other country for the additional tax liability resulting from the secondary adjustment.

Another aspect which demands clarity is with regard to the mandate to carry out secondary adjustments for roll back years covered under an APA. Though it is envisaged that the provisions of Section 92CE would be applicable for AY 2018-19 and subsequent years only, a specific clarification excluding roll back years prior to AY 2018-19 from the ambit of secondary adjustments would be helpful.

It may also be interesting to note that in the event a primary adjustment emanates from out of a MAP between the competent authorities of 2 countries, such settlement would also normally include agreed terms for repatriation of funds involved in the primary adjustment. However, these terms are specific to the particular settlement between the two governments. The terms may vary, but generally allow for the repatriation of funds to be effected either by a direct reimbursement or through an offset of inter-company accounts. Typically, the agreed terms also allow a taxpayer to repatriate within a mutually agreed reasonable time period. In this regard, some clarity is called for in respect of whether the terms in MAP would override the rules (yet to be notified by the Board) in respect of repatriation of funds by the AE.

The Service tax angle

In pursuance to a primary adjustment normally, the secondary adjustment entry would be effected in the following manner in the books of the assessee:

Associated Enterprise A/C	Dr.
To Income A/C	
(Being secondary adjustment entry made arising out of primary adjustment as per transfer pricing law)	

As per the proposed law the amount credited to the AE account has to be remitted to India by the AE within the prescribed time. If such amount is not remitted to India within the prescribed time limit, the same would be treated as a deemed loan to the AE and the assessee in India will be required to pay tax on the notional interest (rate to be specified). Therefore, a factor which crops up while passing the secondary adjustment entry, is on the applicability of service tax, as the same could fall within the ambit of Rule – 4 of Place of Provision of Service Rules, 2012.

Conclusion

An enactment in respect of secondary adjustments in line with the OECD TP Guidelines, would nevertheless put an end to disputes also finding favour with the TP authorities. However, clear cut guidelines on scope and applicability of secondary adjustments, time limit for repatriation, method to be adopted for imputing interest on deemed advances etc will be eagerly awaited. Let us hope all these issues get comprehensively addressed in the months to come thereby leaving no loose ends untied.