Transfer Price Adjustment – Primary and Secondary Adjustment

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Introduction:

Transfer price provisions have been incorporated into tax laws by various countries in order to reduce tax avoidance by artificial shifting of profits from high tax jurisdiction to low/nil tax jurisdiction. Under these provisions, when an entity enters into any transaction with its AE[1], the tax authorities of such country may deny the price at which such transaction is entered and compute the price of transaction at arm's length principle.

For example, ABC Ltd has availed certain services from its AE viz. ABC Inc for an amount of USD 1,000 but income tax authorities may determine the arm's length price ('ALP') of such services at USD 800 and disallow the expense of USD 200 by making transfer price adjustment. However, as ABC Inc raises invoice for USD 1,000, ABC Ltd remits the same to its AE, ABC Inc.

In this scenario, though the adjustments proposed under the transfer price provisions under tax law aim to reduce artificial shifting of profits, such adjustment is not effective enough to reduce the shifting of cash profits to another country.

In order to tackle the above issue, OECD has provided guidance to insert secondary adjustment provisions under the tax laws.

In this article, the concept of transfer price adjustments viz. primary adjustments and secondary adjustments have been discussed in detail.

[1] Associated Enterprise

OECD Guidance:

Before understanding the concept of secondary adjustment in detail, it is required to understand what a transfer price adjustment is and how it effects the tax of corresponding entity in another jurisdiction.

As discussed above, tax laws of particular country may impose transfer price regulations under which any income/expense with the AE has to be computed having regard to the ALP.

Para 1 of Article 9 of tax convention[2] states that where, by virtue of special relation between the enterprises, any profits have not accrued to an enterprise, which would have been accrued had it been entered between independent enterprises, then, such profits may be included in the profits of that enterprise and taxed accordingly.

It means that profits of the enterprise have to be revised to make adjustment in relation to transfer price between the enterprise and its AE. This adjustment is to be considered as primary adjustment or transfer price adjustment while computing the taxable income of the enterprise.

Then the question arises, what about the corresponding adjustment in the books of the AE as it leads to economic double taxation.

Para 2 of Article 9 deals with corresponding adjustment in books of AE which states that other

[2] Reference to OECD Model Tax Convention on Income and on Capital

jurisdiction may make corresponding adjustment under MAP[3] as provided in Article 25 of treaty.

When the corresponding adjustment is made in another jurisdiction, taxable income of the AE gets reduced and taxed accordingly.

However, concept of corresponding adjustment is different from secondary adjustment. As discussed above, under the transfer price adjustment (primary adjustment) or under the corresponding adjustment, profits of the enterprise would be revised to make adjustments. However, these adjustments do not deal with cash adjustment viz. realization of excess amount from AE but deal with revision of profit.

In order to deal with such an issue, it has been proposed to insert secondary adjustment provisions under the domestic laws of a country.

OCED has recommended three ways to deal with secondary adjustment:

- **Constructive Dividends:**

  Under which excess profit lies with the AE would be considered as distribution of dividend by the enterprise to such AE. As amount is considered as dividend, withholding tax obligation triggers in the hands of the enterprise.

- **Constructive Equity Contributions:**

  Under this approach, excess amount lies with the AE would be considered as equity contribution to such AE. As amount is considered as equity contribution, enterprise has to repatriate amount which becomes due to a shareholder.

- **Constructive Loans:**

  Under this approach, excess amount lies with the AE would be considered as loan given by the enterprise to such AE. In this approach, as amount is considered as loan, enterprise has to realise interest on such loan on timely manner.

However, secondary adjustment may result in double taxation unless corresponding credit for the additional tax liability that may result from the secondary adjustment is provided in the other country. Further, commentary[4] on para 2 of Article 9 of Model Tax Convention states that Article does not deal with secondary adjustments which means that a person may not claim relief of under Article 9 as well.

India's Approach:

Considering the recommendations of OECD, Government of India has incorporated secondary adjustment provisions into the Income Tax Act, 1961 ('ITA') in the form of constructive loans. Section 92CE has been inserted into ITA through the Finance Act, 2017.

[3] Mutual Agreement Procedures

[44] OECD commentary on Model Tax Convention on Income and on Capital

Secondary Adjustment	The word secondary adjustment is defined to mean an adjustment in the books of account of the assessee and its associated enterprise to reflect that the actual allocation of profits between the assessee and its associated enterprise are consistent with the transfer price determined as a result of primary adjustment, <u>*thereby removing the imbalance between cash account and actual profit of the assessee.*</u> Which means that when there is a transfer price adjustment in the books of the enterprise to revise the profits such enterprise, books of account should also be adjusted to record amount receivable from the AE on account of primary adjustment thereby removing the inconsistency between the cash account and actual profit.
Situations where secondary adjustment is warranted	Section 92CE states secondary adjustment is required in the following situations: Where a primary adjustment to transfer price: • has been made ***suo motu*** by the assessee in his return of income; • made by the AO has been accepted by the assessee; • is determined by an advance pricing agreement ('APA') entered after 01.04.2017; • is made as per the safe harbour rules; • is arising as a result of Mutual Agreement Procedure ('MAP').
Form of secondary adjustment	India has opted for constructive loan approach. Section 92CE (2) states that where, as a result of primary adjustment, there is an increase in the total income or reduction of loss, the excess money, which is available with its AE, if not repatriated to India with the time prescribed, shall be considered as amount advanced by the enterprise to its AE and notional interest shall be considered on such advance.
Year in which adjustment to be made	Section 92CE states that where the primary adjustment is made in the return of income *suo motu*, assessee is required to make secondary adjustment. For Ex: for FY 2017-18, while filing the return of income (on or before 30.11.2018), if assessee makes any transfer price adjustment, such adjustment shall be considered as adjustment in the FY 2018-19 for repatriation and/or for the computation of interest. Similarly, when the transfer price adjustment is made in the assessment order vide dated 31.10.2020, (which is accepted by the assessee), adjustment shall be considered in the FY 2018-19 for repatriation and/or computation of interest.
Excess Money	Excess money is defined to mean means the difference between the ALP determined in primary adjustment and the price at which the international transaction has actually been undertaken.
Situations where secondary adjustment is not warranted	secondary adjustment is not required to be made when the amount of primary adjustment does not exceed Rs.1 Crore or[5] primary adjustment is made in respect of an assessment year commencing on or before 0.04.2016.
Practical difficulty in secondary adjustment	Though the term secondary adjustment is defined under section 92CE to make adjustments in the books of the assessee and its AE, the question arises is how record entry in the books of account of AE when domestic laws of such country do not provide for it.

[5] The word 'and' has been substituted with word 'or' through Finance Act,2019 retrospective to provide more clarity on applicability of section 92CE.

Relaxations brought in through the Finance Act, 2019	As discussed above, it may be difficult to make accounting adjustment in the books of the AE and repatriate such amount to India. In this regard, section 92CE has been amended through the Finance Act, 2019 to provide the following relaxations: • Assessee may repatriate the excess money from any of the AE of the assessee which is not a resident in India. • Further, new sub sections viz. subsection (2A) - (2D) have been inserted in section 92CE to provide that where the excess money is not repatriated to India within the period specified, may pay additional income tax of 18 percent. In such a case, the assessee is neither under the obligation to repatriate the excess money nor required to compute notional interest on such excess money. The additional income tax paid by the assessee shall be considered as final payment of tax and no credit can be claimed by the assessee or any other person. Further, no deduction for additional income tax is allowed under any other provisions of the Act.

Manner of Computation of Notional Interest:

As stated in section 92CE (2), as excess amount has to be repatriated to India within the time prescribed otherwise, such amount is considered as loan given by the assessee to its AE and notional interest on loan has to be computed at the rate prescribed. In this regard, Rule 10CB has been inserted to compute the notional interest on deemed loan.

Nature of adjustment	Time limit to repatriate the amount	Time period to compute the interest
Suo motu adjustment by the assessee in his return of income.	90 days from the due date of filing of return under section 139(1).	From the due date of filing of return under section 139(1).
Adjustment is made by the AO and the same has been accepted by the assessee.	90 days from the date of the order of AO or appellate authority.	From the date of the order of AO or appellate authority.
Adjustment is determined by an APA which is entered on or after 01.04.2017.	90 days from the due date of filing of return under section 139(1). However, if such APA is entered after such date, 90 days from the end of the month in which such APA is entered.	From the due date of filing of return under section 139(1). However, if such APA is entered after such date, from the end of the month in which such APA is entered.
Adjustment is made as per the safe harbour rules.	90 days from the due date of filing of return under section 139(1).	From the due date of filing of return under section 139(1).
Adjustment is arising as a result of MAP.	90 days from the date of date of giving effect by AO to the resolution arrived under MAP.	From the date of date of giving effect by AO to the resolution arrived under MAP.

Rate of Interest

Where the international transactions are entered in Indian currency	SBI one-year MCLR as on 1st April + 300 basis points.
When the international transactions are entered in foreign currency	Six Months LIBOR as on 30th Sept + 300 basis points.

Reporting Requirements:

Clause 30A of Form 3CD deals with reporting requirements for secondary adjustments made under section 92CE of the Act. ICAI Guidance Note on Tax Audit provides certain guidelines for reporting of secondary adjustment in clause 30A of Form 3CD.

Clause 30A	ICAI Guidance
Primary adjustment has been made during the previous year	ICAI in its Guidance note has stressed on the word 'made' during the year. Hence, the tax auditor is required to report those adjustments which are ***made*** during the previous year and not in respect of previous. Guidance Note further provides that it is advisable to report primary adjustment made in earlier years, if amount is not repatriated to India, as interest amount is imputed till the date of repatriation.
Where the primary adjustment is less than Rs.1Crore.	In this regard, though secondary adjustment is not warranted, ICAI in its Guidance note has mentioned that the tax auditor is required to report primary adjustment though the amount of adjustment is less than Rs.1Crore in clause 30A of Form 3CD.

Interplay with other provisions of the Income Tax Act:

Provision	Interplay
Deemed international transaction under section 92B (2)	As discussed above, section 92CE (2) states that, on account of primary adjustment, if excess money is available with its AE, if such excess money is not repatriated to India, then, such excess amount shall be considered as advance given by the assessee to such AE. Interestingly, section 92B(2), deals with deemed international transaction, states that even though there is no direct transaction with the AE but there is an agreement/arrangement between the AE and the third party, transaction with the third party shall also be considered as international transaction between two AEs. From the above, the question arises is whether secondary adjustment is warranted even for the deemed international transaction as such transaction is not entered with the AE. As there is a reference to international transaction in section 92CE and such term in defined under section 92B which includes deemed international transaction, amount lies with the third party in deemed international transaction shall be considered as amount lies with the AE and section 92CE triggers. Further, section 92B(2) states that the transaction with the third party shall be considered as a transaction with AE. This view also gets support from the Form 3CEB as it is required to provide the name of the AE for the deemed international transaction in Form 3CEB. However, on plain reading of section 92CE, it appears that as AE relationship is mandatory to invoke secondary adjustment provisions.
Deemed dividend under section 2(22)(e)	The next aspect is, whether considering the excess amount lies with the AE as an 'advance' trigger deemed dividend provisions under section 2(22) (e) of the Act.

	Section 2(22) (e) of the Act states that any amount paid by a closely held company, by way of loan or advance, to its shareholder who is holding not less than 10 percent of the voting power, or to any concern in which such shareholder has substantial interest, such advance or loan may be considered as dividend to such shareholder (subject to other conditions). On plain reading of section 2(22)(e) and section 92CE, it appears that secondary adjustment may triggers deemed dividend provisions. However, it may be important to understand that intention behind the insertion of section 2(22)(e) and section 92CE. Section 2(22)(e) has been inserted to curb the artificial distribution of profits whereas section 92CE is a deeming fiction created under the statute to repatriate the amount to India. Which means that section 92CE focuses on repatriation of excess amount and to force the assessee to bring the amount to India, notional interest computation has been inserted. Further, though OECD has provided three option which *inter alia* includes constructive dividend approach, Indian has opted for constructive loan approach. Therefore, it can be understood that there is no intention to consider the excess amount as a dividend. Also, the amendment made by the Finance Act, 2019 provides that if assessee opts to pay additional tax of 18 percent (which is similar to constructive dividend approach), assessee is not required to repatriate the amount. However, clarity may be provided to avoid litigation.
Corresponding adjustment in the books of PE in India	Section 92CE of the Act states that when there is a primary adjustment, the assessee is under an obligation to make secondary adjustment. The definition of secondary adjustment states that secondary adjustment shall be made in the books of the assessee as well as books of the AE. On the other hand, section 92C (4) states that when the income of the assessee is recomputed having regard to the ALP, income of its AE shall not be recomputed to match with the adjustment made to income of the assessee. When assessee is making payment to a nonresident having PE India, the question arises is when there is a primary adjustment in the books of the assessee, whether such adjustment can be made to the income of its AE. On reading of section 92C (4), it appears that though there no scope to make adjustment to the books of the AE. However, the provisions of section 92CE specially provides for making adjustment even in the books of the AE. Further, what section 92CE restricting is that the income of the AE shall not be recomputed having regard to ALP of the assessee. However, section 92C (4) does not have any bar on making adjustment in the books of the assessee viz. payment against the debit note. When such payment made by AE is recorded in its books, such amount may have to be allowed as a deduction or income has to be reduced. The Hon'ble Mumbai Tribunal in the case of Gemological Institute of America Inc[6] has held that, when the royalty amount is refunded by the PE in India to the assessee on account of APA, income of the PE has to be reduced to the extent of such refund. Which means that though section 92C (4) contains restrictions, other provisions shall also be

[6] [2021] 127 taxmann.com 167 (Mumbai - Trib.)

	considered while making the adjustment. However, considering the facts, revenue may litigate the matter to higher forum.