Abusive Tax Structures, Make Way For Budget 2017's Transfer Pricing Combat Weapons

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Among other things, Union Budget 2017 will be remembered for two firsts – the introduction of secondary adjustment and thin capitalisation rules. Both are transfer pricing provisions which will have a far-reaching impact on corporates.

Secondary Adjustment

Since the concept of secondary adjustment is introduced for the first time in this Budget, currently there is no tax paid on this account.

Finance Bill 2017 changes this:

> In order to align the transfer pricing provisions with the OECD transfer pricing guidelines and international best practices a new section will be inserted to provide that the assesse shall make secondary adjustment where the primary adjustment to the transfer price has been made in certain cases:

Arun Jaitley, Finance Minister In Budget 2017 Speech

The new provision will be applicable if the primary adjustment exceeds Rs 1 crore and the excess money attributable to the adjustment is not brought to India within the prescribed time.

Maulik Doshi, a partner at SKP Business Consulting explained that a secondary adjustment implies that the tax payer would not only have to pay taxes on the primary additions to taxable income but also have to record the same in the books of accounts.

> *If such secondary adjustment is not done to the books of accounts, there are no direct penal implications being prescribed but such amount is treated as an advance lying with the associated enterprise and the Indian tax payer has to pay taxes on the notional interest component in respect of such notional advance.*
>
> **Maulik Doshi, Partner, SKP Business Consulting**

The mode of computation and the rate of interest etc would be prescribed in due course, he added.

The Finance Bill 2017 has proposed that a secondary adjustment should be made in scenarios where primary transfer pricing adjustment is made:

- By the tax payer himself suo-moto;
- By the tax officer which has been accepted by the tax payer;
- Based on an Advance Pricing Agrrement entered into by the taxpayer;
- Based on safe harbor declaration done by tax payer; or
- Based on a Mutual Agreement Procedure resolution under the tax treaty

By recording the secondary adjustment in the books of accounts, apart from the corporate tax being paid by the tax payer, there would be additional dividend distribution tax that would need to be paid as and when dividends are distributed out of such profits, Doshi said.

Thus, it increases the tax burden on Indian tax payer as the tax payer is not only subject to corporate tax but also dividend distribution tax as and when dividends are distributed, Doshi added.

Thin Capitalisation Rules

When an entity has a high proportion of debt compared to equity, it is said to be thinly capitalised.

Vivek Gupta, a partner at BMR Advisors explained the concept: Assume an entity wants to invest Rs 10 crore. It invests Rs 1 crore as equity and Rs 9 crore as debt because it knows that the India business is profitable and it can claim the benefit of tax deduction on the interest paid on the Rs 9 crore debt. Such an entity will be called a thinly capitalised one.

Since interest payments generated on debt capital are treated as a finance charge, and are allowable as a deduction in the taxable corporate income, it reduces the corporate tax burden.

It is this abuse that the Finance Bill 2017 seeks to address, Gupta added.

> In order to address the issue of thin capitalisation, a proposal has been made that the interest paid by an Indian company or permanent establishment of a foreign company, shall not be allowed as deduction in computing its taxable profit subject to certain conditions.

Arun Jaitley, Finance Minister In Budget 2017 Speech

The Finance Bill fine print explains the proposal and states that the allowance of interest claimed by an entity to its Associated Enterprises shall be restricted to 30 percent of its earnings before interest, taxes, depreciation and amortization (EBITDA) or actual interest paid or payable to the Associated Enterprises, whichever is less.

The introduction of thin capitalisation is in line with the tax department's programme of aligning Indian tax rules with global norms, Rakesh Nangia, managing partner at Nangia & Co. pointed out. As of today, thin capitalisation rules are present in transfer pricing legislations of various countries and India's adoption of the same reflect India's commitment to adhere to the common Base Erosion and Profit Shifting programme, he added

> *However, Indian thin capitalisation rules provide a deviation from global standards, by allowing carry forward of the disallowed amount for 8 assessment years. Further, there is not much clarity on operation of thin capitalisation rules in case of companies having losses.*
>
> **Rakesh Nangia, Managing Partner, Nangia & Co.**

Nishith Desai, managing partner at Nishith Desai Associates pointed out another issue with thin capitalisation provision. Thin capitalisation rules apply to associated enterprises or related parties. The definition of associated enterprises is so expansive that it could also include within itself third party lenders (other than banks or insurance companies) who may have financed companies 51 percent or more of the book value of the total assets of the borrower, he added.

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