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TAX FLASH NEWS

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Budget 2017: Transfer Pricing proposals

The Finance Minister for the first time presented a combined Fiscal and Railway Budget on 1 February 2017, a reform in itself, with a view to enable the ministries to operationalise all activities from the commencement of the financial year (FY) 2017-18. The Finance Bill, 2017 proposed the following amendments in the Transfer Pricing (TP) regulations:

- **Tax neutral related party transaction exempted from domestic TP provisions**

  The provisions in the Indian Income-tax Act, 1961 (the Act) which deal with expenditure in respect of payment made by a taxpayer to a domestic related party (for e.g. payment made to directors/entities having a substantial interest in the taxpayer's entity, etc.) have been abolished.

  The applicability of domestic TP provisions has now been restricted to only those related party transactions where one of the party enjoys any kind profit linked tax-incentives.

  Transactions between related parties that are tax neutral will not be covered within the ambit of TP provisions from FY 16-17 onwards.

- **Secondary adjustments**

  The Finance Bill, 2017 has introduced the concept of secondary adjustment on TP adjustments.

  A taxpayer is required to make a secondary adjustment, where the primary adjustment to transfer price has been made in the following situations:-

  - *Suo motu* by the taxpayer in the return of income;
  - By the Assessing Officer (AO) during assessment proceedings, and has been accepted by the taxpayer;
  - Adjustment determined by an Advance Pricing Agreement entered into by the taxpayer;
  - Adjustment made as per the safe harbour rules; or
  - Adjustment arising as a result of the resolution of an assessment by way of the mutual agreement procedure under an agreement entered into for avoidance of double taxation.

  'Secondary adjustment' has been explained as an adjustment in the books of accounts of the taxpayer and its associated enterprise (AE) to reflect that the actual allocation of profits between the taxpayer and its AE are consistent with the transfer price determined as a result of primary adjustment i.e. based on arm's length price as may be determined.

  The term secondary adjustment in general parlance based on international practices means that when there is enhancement of taxable profits or reduction in losses due to adjustment to transfer prices charged to AE, the additional amount receivable from the AE should be repatriated by the taxpayer and offered for tax in the country of the taxpayer (in this case India). If the same is not received by the taxpayer, then a secondary adjustment in the form of notional interest on the outstanding amount receivable from the AE (deemed as an advance) should also be offered to tax as an income of the taxpayer.

As per the Budget proposals introduced in the Finance Bill, 2017, the notional interest as explained above will be taxable in the hands of Indian taxpayers if a TP or primary adjustment exceeds INR one crore and the same is not repatriated into the country (India) within the time as may be prescribed.

The manner of computation of interest on the amount deemed as an advance made by the taxpayer to the AE would be prescribed.

The above provisions will be applicable for FY 2016-17 and subsequent years.

- **Introduction of Thin Capitalisation Rules**

  In line with the recommendations contained in the Base Erosion and Profit Shifting (BEPS) Action Plan 4 issued by the Organisation for Economic Cooperation and Development, the Finance Bill, 2017 has introduced proposals relating to thin capitalisation.

  Where an Indian company, or a permanent establishment of a foreign company in India, being the borrower, pays interest exceeding INR one crore in respect of any debt issued/guaranteed (implicitly or explicitly) by a non-resident AE, then the interest shall not be deductible in computing income chargeable under the head 'Profits and gains of business or profession' to the extent, it qualifies as excess interest.

  Excess interest shall mean total interest paid/payable by the taxpayer in excess of thirty per cent of cash profits or earnings before interest, taxes, depreciation and amortisation or interest paid or payable to AEs for that previous year, whichever is less.

  There will be a restriction on the deductibility of the interest in the hands of the taxpayer in a particular financial year to the extent it is excess as explained above. However, the same shall be allowed to be carried forward for a period of eight years and allowed as a deduction in subsequent years.

  The above restrictions shall not be applicable to the taxpayer engaged in the business of banking or insurance.

  These provisions will be applicable for FY 2017-18 and subsequent years.

- **Penalty for furnishing incorrect information**

  A new provision relating to levy of penalty of INR10,000 per default has been proposed to be levied on accountants, merchant bankers or registered valuers, in cases, where during the course of any proceedings, under the provisions of the Act, the AO or Commissioner (Appeals) finds that incorrect information has been furnished by them in any reports or certificates issued by them.

- **Time limit for completion of assessment**

  It has been proposed that for the AY 2018-19, the time limit for making an assessment order under Sections 143 or 144 of the Act shall be reduced from twenty-one months to eighteen months, and for the AY 2019-20 and onwards, the said time limit shall be twelve months from the end of the AY in which the income was first assessable.

Our comments

The removal of TP documentation and certification requirements with regard to expenditures incurred with respect to domestic related parties is a welcome relief for taxpayers. It was an unnecessary compliance burden on taxpayers as it covered the transfer of funds between tax neutral entities thus resulting in minimal or zero tax impact for the government. This move is indeed reflective of the government's endeavour to stay focussed on high-risk areas and reduce litigation in the long run.

Another important amendment is in respect of 'secondary adjustments'. Even though the concept of secondary adjustments is globally accepted by many other countries, but the way it has been incorporated in the Finance Bill, 2017, it appears to be a bit more rigorous, as there is not only a requirement to pay tax on the notional interest income, but there is also a requirement to repatriate the amount of adjustment to India (which seems to be an exchange control issue) as well as account for the same, both in the books of the taxpayer as well as the AE. It may be beyond the control of the taxpayer to ensure that the books of the foreign AEs also account for the primary adjustment made in India. Taxpayers engaged in banking and insurance sectors have been rightly excluded.

Further, for the first time in the Indian regulations, the penalty has been proposed for furnishing incorrect information in reports or certificates on the accountant, merchant banker, registered valuer in order to ensure that such persons undertake due diligence before preparing such certifications.

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