Section 92CE - Secondary adjustments in Transfer Pricing : An Analysis And Emerging Issues

Introduction –

The Finance Act, 2017 has introduced a new section *'92CE – Secondary adjustments in certain cases'* w.e.f. 01-04-2018. Prior to insertion of this section, Department did try to make secondary adjustments for difference between the ALP price and actual price of international transaction. Few examples are. Vodafone's/Shell companies cases, few AMP cases etc. However High Court and Tribunals have rejected this adjustment stating that Indian Transfer Pricing regulations have no specific provisions for secondary adjustment. To overcome these precedents and to align the transfer pricing provisions in line with OECD transfer pricing guidelines and international best practices, Finance Act, 2017 introduced section 92CE.

Analysis of section 92CE –

As per sub section (1) of section 92CE, the secondary adjustment shall be made if there is a primary adjustment on account of –

(i) has been made suo moto by the assessee in his return of income; or
(ii) made by the Assessing Officer has been accepted by the assessee; or
(iii) is determined by an advance pricing agreement entered into by the assessee under section 92CC; or
(iv) is made as per the safe harbour rules framed under section 92CB; or
(v) is arising as a result of resolution of an assessment by way of the mutual agreement procedure under an agreement entered into under section 90 or section 90A for avoidance of double taxation

The primary adjustment has been defined in clause (iv) of sub section (3) of section 92CE as under –

"primary adjustment" to a transfer price, means the determination of transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the assessee;

Similarly secondary adjustment is defined in clause (v) of sub section (3) of section 92CE as under –

"secondary adjustment" means 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, thereby removing the imbalance between cash account and actual profit of the assessee.

The proviso to sub section (1) to section 92CE however carves out an exception and provides that secondary adjustment is not applicable if –

(i) the amount of primary adjustment made in any previous year does not exceed one crore rupees; and
(ii) the primary adjustment is made in respect of an assessment year commencing on or before the 1st day of April, 2016.

Sub section (2) of section 92CE provides that where as a result of primary adjustment to the transfer price, there is an increase in the total income or reduction in the loss, as the case may be, of the assessee, the excess money which is available with its associated enterprise, if not repatriated to India within the time as may be prescribed, shall be deemed to be an advance made by the assessee to such associated enterprise and the interest on such advance, shall be computed in such manner as may be prescribed .

CBDT wide Rule 10CB of the Income Tax Rules prescribed time limit within which excess amount has to be brought back in India. Rule 10CB further provides the rate of interest that will be charged if assessee fails to bring such excess amount in India within time prescribed.

As per Clause (1) of Rule 10CB, excess money should be repatriated to India not later than 90 days from –

Sr. No	**Primary adjustment on account of**	**Time limit of 90 days to be counted from**
1.	Has been made suo moto by the assessee in his return of income;	The due date of filing of return under sub-section (1) of section 139 of the act
2.	Made by the Assessing Officer has been accepted by the assessee;	The date of the order of Assessing Officer or the appellate authority, as the case may be
3.	Is determined by an advance pricing agreement entered into by the assessee under section 92CC;	The due date of filing of return under sub-section (1) of section 139 of the Act
4.	Is made as per the safe harbour rules framed under section 92CB; or	The due date of filing of return under sub-section (1) section 139 of the Act
5.	Is arising as a result of resolution of an assessment by way of the mutual agreement procedure under an agreement entered into under section 90 or section 90A for avoidance of double taxation	The due date of filing of return under sub-section (1) section 139 of the Act

It is however noted that CBDT has proposed draft rules on 19th June 2018 for modification of existing rule 10CB in case of Advance Pricing Agreement (APA) and Mutual Agreement Procedure (MAP). As per draft rules, commencement of 90 days' time limit for the purpose of secondary adjustment would be as follows:

• In case of APA, from the date on which APA has been entered into by the assessee

• In case of MAP, from the date of giving effect by the Assessing Officer to the resolution reached under the MAP.

If this changes happened, Rule 10CB may be modified to this extent.

As per clause (2) of Rule 10CB , the rate of interest which will be imputed to excess money not repatriated within 90 days from the date specified will be as under –

Sr. No	Denomination of international transaction	Rate of Interest
1.	The international transaction is denominated in Indian rupee	One year marginal cost of fund lending rate of State Bank of India as on 1st of April of the relevant previous year plus three hundred twenty five basis points
2.	The international transaction is denominated in foreign currency	Six month London Interbank Offered Rate(LIBOR) as on 30th September of the relevant previous year plus three hundred basis points

The specified rate of interest will be applied to excess money which assessee failed to brought in India. Excess money has been defined by clause (iii) of sub section (3) of section 92CE as under –

"excess money" means the difference between the arm's length price determined in primary adjustment and the price at which the international transaction has actually been undertaken

It is further to be noted that section 92CE is applicable only in case of primary adjustments made with respect to international transaction and not applicable to the specified domestic transactions.

International position over secondary adjustments –

The Article 9 of Model Tax Convention does not deal with the issue of secondary adjustments. However, the concept of secondary adjustment is accepted by OECD TP guidelines in order to ensure that TP adjustment reach its logical conclusion. Para 4.66. of OCED TP guidelines broadly prescribes 3 approaches which are as under –

1) **Deemed Dividend Approach –**

Para 4.68 of OECD guideline explains it as – *'a country making a primary adjustment to the income of a subsidiary of a foreign parent may treat the excess profits in the hands of the foreign parent as having been transferred as a dividend, in which case withholding tax may apply.'*

2) **Deemed Loan Approach –**

Para 4.69 of OECD guideline explains it as – *'the tax administration making a primary adjustment treats the excess profits as being a constructive loan from one associated enterprise to the other associated enterprise. In this case, an obligation to repay the loan would be deemed to arise. The tax administration making the primary adjustment may then seek to apply the arm's length principle to this secondary transaction to impute an arm's length rate of interest. The interest rate to be applied, the timing to be attached to the making of interest payments, if any, and whether interest is to be capitalised would generally need to be addressed. The constructive loan approach may have an effect not only for the year to which a primary adjustment relates but to subsequent years until such time as the constructive loan is considered by the tax administration asserting the secondary adjustment to have been repaid.'*

3) **Capital Contribution Approach**

This approach treat the excess profits as deemed equity contribution.

Worldwide many countries adopted Deemed Dividend Approach. However as evident from section 92CE, India has adopted Constructive Loan Approach for secondary adjustments. Presently only U.K. has proposed constructive loan approach however it is at consultation stage.

Emerging issues –

1) **Whether provisions of section 92CE are applicable prospectively or retrospectively ?**

If primary adjustment accepted by the assessee for reasons mentioned in sub section (1) of section 92CE, secondary adjustment is applicable. However secondary adjustment is not applicable if primary adjustments made in respect of the assessment year commencing on or after 1st day of April 2016(i.e. AY 2016-17 or before) and the primary adjustments does not exceeds Rs 1 crore. The use of word 'and' has created doubt regarding retrospectivity of applicability of section 92CE. For e.g. If the primary adjustments relates to AY 2014-15 but exceeds Rs 1 crores then does it means that provisions of sec 92CE providing for the secondary adjustments will be applicable ? This doubt is fortunately cleared by the CBDT vide its **Circular No. 52/2017 dated 15th June, 2017** whereby it is made clear that *'The provision shall be applicable to primary adjustments exceeding one crore rupees made in respect of the assessment year 2017-18 and onwards.'* Therefore section 92CE is applicable prospectively.

2) **Effective date of application of provisions of section 92CE –**

As per section the provisions of section 92E will be applicable from 01.04.2018 i.e. AY 2018-19 onwards. Further the memorandum to the Finance Bill, 2017 states as under –

“This amendment will take effect from 1st April, 2018 and will, accordingly, apply in relation to the assessment year 2018-19 and subsequent years.”

However, as per proviso to sub section (1) to section 92CE provides that no secondary adjustment to be made if primary adjustment is pertaining to AY 2016-17 or earlier. Hence, as per said proviso secondary adjustments need to be made if primary adjustment pertains to AY 2017-18 and onwards.

The question arises if section is applicable from 01.04.2018, how can it is applicable to AY 2017-18?

It is to be noted that secondary adjustment pertaining to AY 2017-18 will first become applicable from AY 2018-19 only. It is because the time limit of 90 days to repatriate funds to India as mentioned in Rule 10CB starts from date of filing return u/s 139(1) or date of order of AO or appellate authorities, as the case may be, which obviously falls in the next assessment year and hence secondary adjustment pertaining to AY 2017-18 will be made in AY 2018-19.

It can be understood with the help of an example. Say, Rs 10 crore primary adjustment is made for AY 2017-18 by assessee suo moto. The due date for filing the return of income to the assessee is 30th November 2017. As per Rule 10CB, assessee has to brought excess money of Rs 10 crore within 90 days from due date u/s 139(1) i.e. 30-11-2017 which will end say on 28-02-2018. If assessee fails to bring excess money by 28-02-2018, then interest at the rate prescribed in Rule 10CB(2) will be computed and will be deemed as income of FY 2017-18 i.e. AY 2018-19.

This view further gets strengthen from the recent amendment in Form 3CD wherein disclosure requirement regarding secondary adjustments is incorporated in clause No 30A from AY 2018-19. The Implementation Guide w.r.t. Notification No. 33/2018 dated 20.07.2018 issued by the Institute of Chartered Accountants of India also affirms the above view.

3) Limit of Rs 1 crore mentioned in proviso to section 92CE(1) – how to compute ?

Another issue that arise is how the limit of Rs 1 crore is to be computed i.e. whether it is Rs 1 crore per primary adjustment or it is Rs 1 crore per AE? The entire scheme of section 92CE suggest that the limit of Rs 1 crore is applicable for aggregate of primary adjustments made during the previous year. It is because clause (i) of Proviso to section 92CE(1) states that no secondary adjustment be made if the amount of primary adjustment made *in any previous year* dos not exceed Rs 1 crore. Therefore, the limit of Rs 1 crore is for entire previous year and not per adjustment basis.

The second issue which arise for consideration is whether the limit of Rs 1 crore is applicable per Associated Enterprise(AE) wise or aggregate of all the primary adjustments made with all the AEs during the previous year. In this respect there are two possible interpretation. Section 92CE(3)(v) defines secondary adjustment which states that an adjustment in the books of account of the assessee and its associated enterprise. Going by this definition, one may argue that the limit of Rs 1 crore primary adjustment be considered per AE basis. However, another view may also be possible based on the fact that the word used in the proviso is 'in any previous year' and hence all the primary adjustments pertaining to all the AEs during the previous year to be considered while deciding the limit of Rs 1 crore.

4) **Whether section 92CE is applicable to deemed international transaction u/s 92B(2) ?**

Sub section (2) of section 92B deems certain transactions between two unrelated parties as International transaction entered into between two associated enterprises. Therefore section 92B(2) deems certain persons in specified situation as AEs, though as per definition of section 92A(1) 92A(2) they are not AEs. The question therefore arises that whether such provisions of section 92CE will be applicable or not?

The one view is the provisions of section 92CE will be applicable to deemed international transactions u/s 92B(2) since what section 92B(2) provides is to ignore the apparent arrangements and look at the substance of transaction which are in fact like transaction entered into between two AEs. Therefore it may be argued that there is no need to make distinction between cases of section 92B(1) and 92B(2). Further as per Explanation to Rule 10CB, international transaction is defined to have same meaning as in section 92B i.e. 92B(1) as well as 92B(2). So, it can be said that section 92CE is applicable to deemed international transaction u/s 92B(4).

The second view is provisions of section 92CE(2) will not be applicable to deemed international transaction u/s 92B(2). This is because , the term 'associated enterprise' for the purpose of section 92CE is defined in section 92CE(3)(i) as *'have same meaning assigned to in sub-section (1) and sub-section (2) of section 92A'*. Had legislature wanted to cover case of every AE(including deemed AEs), it would not have separately defined AE for the purpose of section 92CE. Since it has specifically defined, meaning has to be confined to expressed intention and not beyond that. Further, section 92B(2) is a deeming fiction and it is trite that a deeming fiction should be concluded logically and cannot be stretched beyond intended provision. Therefore the deemed AEs u/s 92B(2) are not coved u/s 92CE.

One has to wait till appellate authorities authoritatively decide this issue.

5) **Calculation of interest – whether from the first day or from the expiry of 90 days period?**

As per Rule 10CB, if assessee fails to repatriate excess money within 90 days from the dates specified i.e. due date for filing return u/s 139(1) or date of assessment order or appellate authorities order, as the case may be, such excess money will be deemed as an advance to such AE and interest at the rate specified in Rule 10CB(2) will be computed and deemed as income. The moot question that arises is from which date such interest is to be computed? Is it to be computed from the first date after the expiry of due date of filing of return of income u/s 139(1) or date of assessment order or appellate authorities order as the case may be? Or is it to be computed from the next day after the expiry of the period of 90 days provided in rule 10CB(1) ? The purposive interpretation may suggest that later view is the better view.

6) Computation of interest in perpetuity ?

If excess money arising due to primary adjustment not repatriated within time prescribed, it will be treated as deemed advance and interest thereon shall be calculated at rate prescribed. It is to be noted that till the excess money is not repatriated to India, it will be deemed as an advance. Therefore, such excess money will be deemed as an advance in perpetuity and interest thereon will be charged year after year till such amount is actually repatriated. This will result in uncalled for hardship to assessees.

7) **Jurisdiction of the Indian Income Tax Authorities to compel foreign AEs to make adjustments in their books of accounts** –

As per section 92CE(3)(v) secondary adjustment means adjustment in the books of the assessee as well as its associated enterprise to reflect the actual allocation of profits. As per this section an obligation is casted upon Indian AE as well as counterpart non-resident AE. It is however questionable as to how Indian Tax Administration can have jurisdiction in dictating non-resident AE to make adjustment in its books of accounts and whether it is really within the competency of Indian I.T. Authorities to demand compliance which is practically very difficult if not impossible.

Further it would be difficult for AE to repatriate the money to India on account of secondary adjustment as the income-tax laws and any other relevant laws pertaining to such country may not allow to repatriate money. Further the AE would have paid tax on such amount in its home country. This would lead to double taxation.

8) Applicability of section 2(22)(e) –

As per section 92CE(2), if excess money is not repatriated within time prescribed, the cash equivalent to primary adjustment will be treated as deemed advance.

Section 2(22)(e)of the I.T.Act,1961 provides that if a company(other than a company in which public is substantially interested) makes an advance or loan to shareholder beneficially holding more than 10% stake, such loan or advance will be deemed a ‘dividend’ and accordingly taxable.

There may arise a situation where these two independent deeming fictions will become applicable due to non-repatriation of primary adjustment amount. It may lead to double taxation. This aspect requires clarification from government.

9) Secondary adjustment arising in case of overall TNMM –

Taxpayers having complex business structures and dealing with multiple overseas AEs, do follow overall TNMM at times. In their case, if AO makes a primary adjustment in transfer price by accepting such application of overall TNMM, an issue may arise as to which foreign AE needs to repatriate the amount of primary adjustment to Indian assessee in order to prevent application of secondary adjustment. A general solution could be to apportion the primary adjustment amongst various AEs in ratio of international transactions. However there may be chances where department may harp on transaction by transaction approach, in which case difficulty may arise.

10) Reporting aspects of secondary adjustments in Form 3CD w.e.f. 20.08.2018 -

The CBDT vide notification no. 33/2018/F No 370142/9/2018-TPL dated 20th July 2018, has notified amendments to Form No 3CD which became applicable from 20th August, 2018. The one of such amendment is clause 30A which requires reporting regarding secondary adjustments made pursuance to section 92CE. Clause 30A requires reporting of whether primary adjustment to transfer price, as referred to in section 92CE(1), has been '*made'* during the previous year. As per Implementation guide issued by ICAI, the primary adjustment made during the previous year may not necessarily relate to the previous year under consideration of audit report. It suggests that each and every type of primary adjustment made in the relevant financial year be disclosed in the audit report. It provides example where taxpayer makes a voluntary adjustment in his return of income filed in November 2019 (pertaining to FY 2018-19). In that case, Such primary adjustment is to be reported in the tax audit report of FY 2019-20 filed on or before November 2020, for the reason that the primary adjustment has taken place in November 2019 (i.e. during FY 2019-20).

As per Implementation Guide primary adjustments for earlier years prior to assessment year 2017-18, or primary adjustments totaling less than Rs. 1 crore for a previous year, which do not warrant a secondary adjustment, should also be reported under clause 30A(a)(i).

The implementation guide further provides that tax auditor has to verify the computation of interest u/s 92CE on excess money at appropriate rate as per Rule 10CB.

The implementation guide further provides guidance as to the date up to which the imputed interest income is to be reported – whether interest income imputed till the end of the previous year is to be reported or whether interest income imputed up to the date of furnishing of Tax Audit Report is to be reported? It advises that since the reporting is for the previous year, tax tax auditor to ensure that the amount of interest imputed till the end of the previous year is furnished.

11) FEMA vs. Section 92CE–

Section 8 of the Foreign Exchange Management Act, 1999 (“FEMA”) requires mandatory repatriation of funds within nine months in respect of any amount receivable from outside India. As per definition of secondary adjustment in section 92CE(v), the Indian entity is mandated to record the amount of secondary adjustment as a receivable in its books of accounts. Therefore in such a situation, the Indian assessee will be duty bound to receive the amount of receivable within six months (or time as may be prescribed), failing which the Indian taxpayer could be subject to penalties under FEMA.

Further, whether mere passing an accounting entry depicting receivable from AE to comply with section 92CE of the I.T.Act, 1961 would result in contravention of FEMA or not has to be examined. This may pose a significant challenge in case of primary adjustment made by AO pursuant to disallowance of expenditure. In such case, excess funds have already been repatriated to foreign AEs by an Indian assessee. Issues as to how such money can be repatriated to India and how compliance of FEMA be made needs further deliberation.

12) Some other issues –

Following issues may also be considered –

- What if AE relationship cease to exist as on the date of acceptance of primary adjustment by assessee? In that case, whether provisions of section 92CE will be applicable?
- In respect of Unilateral APAs that have been entered till date, there was no provision relating to secondary adjustments in the statute. As a result, APAs have been concluded wherein terms that are not consistent with the Section 92CE have been imposed on taxpayers. In view of a specific provision having been introduced, APAs signed till the date of introduction of section 92CE may be disqualified which will create unwanted situation.
- Applicability of section 92CE has to be restricted only to cases satisfying the base erosion test. The provisions, as presently worded, may give rise to an interpretation that even where the primary adjustment is made in the hands of non-resident, secondary adjustment follows. As a consequence, it may be interpreted as allowing repatriation of funds outside India, which may not be permitted even in terms of FEMA/ RBI regulations

Conclusion :

After introduction of section 92CE, taxpayers should be more cautious to enter into international transactions at ALP to avoid primary and its corresponding secondary adjustments. Section 92CE though is introduced to bring actual excess money to India, it is however difficult to conclude that said purpose will be served firstly due to the ambiguous language employed in the drafting of said section and secondly due to impossibility of complying with the certain provisions such as compelling changes in the books of accounts of Non resident AE.