India: Proposed changes to transfer pricing regulations

February 28, 2017

In brief

The recently announced Indian Budget 2017 (the Budget) proposes significant amendments to the Indian transfer pricing law. The three key proposals of the Budget relevant to transfer pricing provisions are:

- Introduction of a secondary adjustment mechanism.
- Restriction on deduction of interest paid or payable to associated enterprises (AEs) to 30% of earnings before interest, depreciation, tax, and amortisation (EBIDTA).
- Exclusion of certain transactions from the ambit of domestic transfer pricing provisions.

The proposals will be formalized as a part of the Indian legislation upon assent of the President of India, either in the current form or with some modifications.

In detail

Introduction of secondary adjustment mechanism

A secondary adjustment, which follows a primary adjustment, seeks to reflect in the books of AEs such allocation of profits as is consistent with the transfer price determined in a primary adjustment.

A primary adjustment is the difference between the transfer price determined based on the arm's-length principle and the transfer price at which the transaction took place. This difference also represents the 'excess money' with the AE that is required to be repatriated to India. If such 'excess money' is not repatriated to India, it will be considered as an advance and interest will be computed thereon.

The time limit for repatriation and manner of computation of interest (rates, duration, etc.) will be prescribed later.

Unlike several jurisdictions where secondary adjustments commonly take the form of constructive dividends, India instead has proposed to adopt the constructive loan approach.

Secondary adjustments will be required in case of the following primary adjustments:

- *Suo-moto* adjustment offered by the taxpayer.
- Adjustment made by the Tax Officer and accepted by the taxpayer.
- Adjustment determined by an Advance Pricing Agreement (APA).
- Adjustment made as per Indian safe harbor rules.
- Adjustment arising as a result of a Mutual Agreement Procedure (MAP) resolution.

The language in the Memorandum explaining the Budget proposals suggests that the intent is to make these provisions applicable with respect to primary adjustments made in respect of Fiscal Year 2016-17 and subsequent fiscal years (April 1 to March 31).

However, at this stage, there is some uncertainty around this aspect.

Restrictions on interest deductions

Action 4 of the Base Erosion and Profit Shifting (BEPS) initiative of the Organisation for Economic Co-operation and Development (OECD) recommended alternate approaches for countries to limit tax base erosion through interest deductions and other financial payments. As India's response to that action plan, the Indian Budget 2017 proposes to limit tax deduction of specified interest expenses.

The provisions will apply for Fiscal Year 2017–18 and subsequent years.

The provisions will apply to taxpayers that are Indian companies or permanent establishments of foreign companies in India. Taxpayers engaged in banking or insurance business have been excluded.

The provisions will apply to interest paid or payable to:

- foreign AEs, or
- third-party lenders, where the underlying debt is backed by an implicit or explicit guarantee, or equivalent deposit from foreign AEs.

The provisions will not apply to interest paid or payable up to INR 10 million (approximately USD 150,000).

Interest in excess of 30% of EBITDA is proposed to be disallowed for tax purposes and will be eligible for carry-forward up to eight consecutive years subject to the above limit. An illustration to demonstrate how the provisions will work follows:

EBITDA	100
Interest paid to AEs (A)	15
Interest paid to third parties (B)	20
30% of EBITDA	30
Disallowance to be lower of: Total Interest (A+B = 35) – 30% of EBITDA or Interest paid or payable to AEs	5

As may be observed from the above illustration, some interest may be disallowed even if the interest to AEs is less than 30% of EBITDA.

Rationalization of domestic transfer pricing provisions

With effect from Fiscal Year 2016–17, domestic transfer pricing provisions will only apply to transactions where at least one of the transacting entities is eligible for tax holiday. Transactions involving expenditure to specified persons have been excluded from the scope of domestic transfer pricing provisions.

The takeaway

There is some uncertainty regarding how the provisions relating to secondary adjustments and those relating to interest deductions would apply as a practical matter. Representations have been made to the Government of India to consider recommendations intended to:

- address ambiguities;
- align with the underlying intent of the provisions and growth objectives of the Government of India; and
- provide practicable solutions from the perspective of easing implementation for both taxpayers and Revenue.

We will keep a close watch on developments and provide further analysis once the Indian President's assent comes through.

Meanwhile, please click here to access our webcast titled "Second Avataar of TP in India: Forging ahead", discussing key issues arising from the proposed provisions.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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