Secondary Adjustment

- An Update

Secondary Adjustment – An Update

The cornerstone of every industry practice is a tiny – yet impactful leap towards improving them. While the Union Budget has seen a plethora of changes in the direct tax laws, India has signalled for incorporating secondary adjustments in transfer pricing regulations on the international tax front. In a bid to broadly categorise the tax amendments proposed, an emphasis is provided on clarifying taxpayer's position in tax courts on one hand, and on another hand, adopting global best practices with adoption of BEPS Action plan 4 pertaining to interest deductions and incorporation of secondary adjustments. While secondary adjustments have already been accepted by some countries internationally, our Budget memorandum gives a flavor of adoption of global best practices. It would be interesting to note how such concept shall be practically implemented in the Indian transfer pricing regulations.

The new provision of section 92CE is now proposed to be applicable from Assessment Year 2018-19 (as per Finance Bill 2017) but it also considers Transfer pricing adjustments made in AY 2017-18.

1. What is primary adjustment?

Primary adjustment refers to increase in the total income or reduction in the loss of the assessee due to non-maintenance of arm's length price for the transactions between the associated enterprises.

2. What is Secondary Adjustment?

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 because of primary adjustments, thereby removing the imbalance between cash account and actual profit of the assessee.

As per the OECD's Transfer Pricing Guidelines, secondary adjustment can be considered as deemed dividends, constructive equity contributions, or constructive loans or advance. The Finance Bill has proposed to treat secondary adjustments as advances given (if not repatriated to India) to respective associated enterprise which shall suffer transfer pricing adjustment. These advances are eligible to compute interest forming part of total income of assessee.

Secondary adjustment can be understood with the help of the following example:
Example:

- Total declared income Rs. 100 crore
- Adjustment of Rs. 10 crore on the international transaction

The computation would be as follows:

Particulars	Amount (Rs. crore)
Declared income	100
Add: Primary adjustment	10
Add: Secondary adjustment (treat 10 crores as advance given to Associated Enterprise, if not repatriated, and impute an interest, say @ 10%)	1
Total adjusted income	**111**

3. <u>In what situation Secondary Adjustment will be applicable?</u>

Secondary adjustment is attracted when primary adjustment is made by:
1. Assessee himself in Return of Income – Self Adjustment.
2. Assessing officer and accepted by assesse – Assessed Income.
3. Assessing officer/assessee based on Advance Pricing Agreement (APA) entered by assessee under section 92CC.
4. Assessing office as per Safe Harbour Rule frame under section 92CB.
5. Assessing office on account of result of an assessment by way of Mutual Agreement Procedure under an agreement entered into under Section 90 or Section 90A.

4. <u>What are the exception to Secondary Adjustment?</u>

The provision of Secondary Adjustment will not be applicable in the following two scenarios, i.e.
1. Where primary adjustment does not cross threshold of Rs. 1 crore in any previous year, and
2. Primary Adjustment made on or before Assessment Year 2016-17.

<u>Conclusion</u>

Where a primary adjustment is computed and the same does not fulfill the above-mentioned exceptions, then it is inevitable to avoid secondary adjustment, provided the deemed advance is not settled in cash. Following are our suggestions:
1. Planning of transfer prices goes a long way in avoiding transfer pricing disputes
2. Important to document the price setting mechanism in a transfer pricing policy document
3. While a primary adjustment is foreseen, it is important to settle the adjustment in cash position.

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