SECONDARY ADJUSTMENT (SECTION 92CE) AND LIMITATION OF INTEREST (SECTION 94B)

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ABBREVIATIONS

the Act	Income-tax Act, 1961	OECD	Organisation for Economic Cooperation and Development
the Rules	Income-tax Rules, 1962	BEPS	Base Erosion and Profit Shifting
PA	Primary Adjustment	LOI	Limitation of Interest
SA	Secondary Adjustment	PGBP	Profits and Gains of Business or Profession
ALP	Arm's Length Principle	PE	Permanent Establishment
BOA	Books of Account	NR	Non-resident
AE	Associated Enterprise	TAR	Tax Audit Report
TP	Transfer Price	FS	Financial Statement
WOS	Wholly Owned Subsidiary	c/f or b/f	Carried Forward or Brought Forward

Sec. 92CE v. Sec. 94B

S.92CE	Excess money left with an AE	Deemed debt to AE	Notional Interest Income
S.94B	Excess Interest paid to an AE	Actual debt from AE	Actual Interest Expense

Part of TAR instead of TP reporting

SECONDARY ADJUSTMENT SECTION 92CE

BACKDROP

- Budget Speech of 2017 said:

  *"In order to **align** the transfer pricing provisions with the **OECD transfer pricing guidelines and international best practices**, it is proposed to insert a new section to provide that the assessee shall make **secondary adjustment** where the primary adjustment to the transfer price has been made in certain cases. The provision shall apply if the primary adjustment exceeds one crore rupees and the excess money attributable to the adjustment is not brought to India within the prescribed time."*

OECD TP GUIDELINES RECOMMENDED SA

Types of SA

- Constructive Dividend
- Constructive Equity Contribution
- Constructive Loans

India opted to treat SA as Loan.

Purpose/ Rationale of SA

- Alignment of **Cash Profit** with TP (i.e. PA)
- Repatriate the **FOREX back** to India
- If not repatriated within prescribed time, then to be treated as interest bearing advance
- Notional Interest income on such advance subject to tax

RELEVANT DEFINITIONS

1. Primary Adjustment

means the **determination of transfer price** in accordance with the **arm's length principle** resulting in:

(i) an increase in the total income of the assessee; or

(ii) reduction in the loss of the assessee.

PA Illustrations

Interest Free Loan to subsidiary / AE

Guarantee to overseas AE without any commission

Support services provided by Indian AE without mark-up

Excess royalty / management services payment

Export / Import of Goods if at lower / higher rate than ALP

RELEVANT DEFINITIONS

2. Secondary Adjustment

means an adjustment in BOA of the assessee and its AE to reflect that the actual allocation of profits between the assessee and its AE are consistent with the TP determined as a result of a PA, thereby removing the imbalance between cash account and actual profit of the assessee.

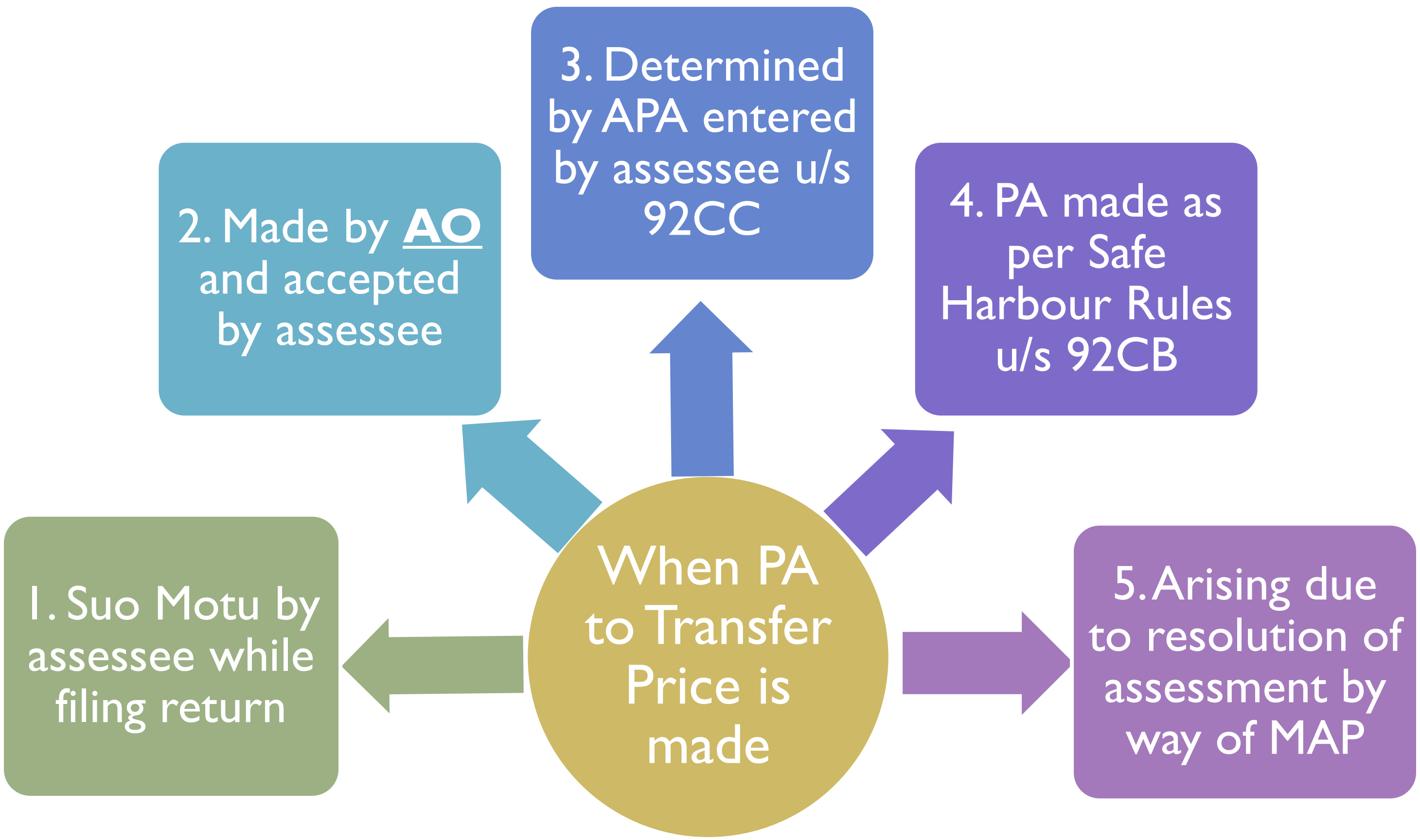
3. Excess Money means *difference between ALP determined in PA and the price at which international transaction has been undertaken.*

ISSUES IN SA DEFINITION

"adjustment in BOA of assessee and its AE"

- How can AE make such adjustment, is it regulated by Indian laws?
- If AE doesn't make such adjustment, will this section be operative?
- If similar provision is applicable in AE's country, whether any deduction can be taken by Indian entity when it pays such SA amount to AE in that country? Subject to FEMA?
- Can this lead to Double taxation?

SEC. 92CE (SA) - APPLICABILITY



When SA applicable, Excess Money to be repatriated to India within prescribed time.

SA APPLICABILITY – EXCEPTIONS

Proviso to Sec. 92CE (1)

Amount of PA → Less than equal to Rs. 1 Crore → Not applicable

OR

[Clarified through Circular No. 2/2018 to read **“and”** as **“or”**.]

PA for or before AY 2016-17 → Not applicable → AY 2017-18?

CONSEQUENCES OF NON-REPATRIATION OF EXCESS MONEY

Deemed as advance

Notional interest on such deemed advance charged

- Rule 10CB – Computation mechanism

Whether law of AE's country permits such repatriation?

TIME LIMITS FOR REPATRIATION (RULE 10CB)

- Repatriation of excess money u/s 92CE(2) to be done <= 90 days from
  - Due date of Return filing u/s 139(1)
    - When assessee makes PA suo motu
    - APA entered by assessee u/s 92CC
    - PA made as per Safe Harbour Rules u/s 92CB
    - PA arising due to resolution of assessment by way of MAP
  - Date of order by **<u>AO or Appellate Authority</u>**, as case may be
    - When assessee accepts the order of PA

Conflicting with main Sec. which says order of only AO

Draft Rule 10CB (19/06/2018)

- Date when APA entered by assessee
- Date when AO giving effect to resolution under MAP under Rule 44H

RATE OF INTEREST (RULE 10CB)

Calculation of Imputed/ Notional Interest on excess money not repatriated within prescribed time

- International Transaction is in **INR**
  - 1 year Marginal Cost of Fund lending rate of SBI as on April 1 of PY (8.00% as on 01/04/2017)

    +

    325 Basis Points

- International Transaction is in **Foreign Currency**
  - 6 month LIBOR as on September 30 of PY (1.51% as on 30/09/2017)

    +

    300 Basis Points

POINTS TO PONDER

From which date interest to be calculated?

Whether interest to be compounded (i.e. whether Interest on interest) or only simple interest?

If amount as per SA not repatriated within 3 years of becoming due whether assessee can write-off the same? Or is it for perpetuity?

- **In case of T.R.F. Ltd. v. CIT (2010) 190 Taxman 391 (SC), Hon'ble SC held:**
- *"it is not necessary for assessee to establish that debt, in fact, has become irrecoverable; it is enough if bad debt is written off as irrecoverable in accounts of assessee."*

What if AE ceases to exist or becomes bankrupt? Whether "*lex non cogit ad impossibilia*" applicable?

- Various judgements can be relied upon including T.R.F. Judgement of Hon'ble SC, as such cases would be **beyond the control of asseessee**. **[(2010) 323 ITR 18 (Karnataka); (2006) 154 TAXMAN 240 (BOM.); (2013) 37 taxmann.com 332 (Madras); (2005) 277 ITR 246 (BOM.)]** As this would be against principles of natural justice as then assessee would not have any power.

POINTS TO PONDER

In what ratio repatriation to be done in case blanket method like TNMM applied to all the international transactions with multiple AEs?

- **Illustration:** I Co. having transactions of purchases and sales of goods with its 8 overseas AEs and for benchmarking TNMM has been used as MAM @ 12% PLI. PA have been done taking 15% PLI. Suppose 3% amounts to Rs. 30 crores, in what ratio such SA to be done in name of those 8AEs.

Whether such loan to be treated as deemed dividend u/s 2(22)(e)?

- No, as the loan or advance have to be actually paid u/s 2(22)(e) and no such payment have been actually done.

In case APAs rollback provisions applicable for max 4 earlier PYs along with 5 PYs [Sec. 92 CC(4) and (9A)], whether SA would have to be made for AY before AY 2017-18?

- No, as per plain reading of the exclusion.

Whether SA made through JV acceptable? Whether this is contravention of FEMA?

- Sec. 92CE(2) mentions repatriation, so cannot be adjusted through JV. Cases on 269SS/ 269T:
  - Triumph International Finance 345 ITR 270 (Bom.) [supports repatriation against Journal Entry]
  - Natvarlal Purshottamdas Parekh 303 ITR 5 (Guj.) [supports Journal Entry]
  - Noida Toll Bridge Co. Ltd (262 ITR 260) (Delhi) [supports Journal Entry]
  - Worldwide Township Projects Ltd (367 ITR 433) (Delhi) [supports Journal Entry]

CLAUSE 30A* OF TAR

30 A(a) Whether primary adjustment to transfer price, as referred to in sub-section (1) of section 92CE, has been made during the previous year.

(b)If yes, please furnish the following details

Select

In case this answer is **Yes**

*Inserted vide Notification No. 33/2018 dated 20/7/2018 effective from 20/8/2018.

S.No.		Under which clause of sub-section (1) of section 92CE primary adjustment is made ?	Amount (in Rs.) of primary adjustment	Whether the excess money available with the associated enterprise is required to be repatriated to India as per the provisions of sub-section (2) of section 92CE.	If yes, whether the excess money has been repatriated within the prescribed time.	If no, the amount (in Rs.) of imputed interest income on such excess money which has not been repatriated within the prescribed time	Expected date of repatriation of money
1		Select		Select	Select		DD/MM/YYYY
1		(i) suo motu by assessee	5,00,00,000	Yes	Not Due		As confirmed by client

Add Delete

Note: As per Rule 10CB repatriation of excess money is permitted upto 28/02/2019 (90 days from 30/11/2018). Accordingly, no notional interest offered to tax till TAR reporting date.

RESPONSIBILITY AS TAX AUDITOR

S. No.	Audit procedure	Documentation
1	To verify any PA made in PY	➢ TP Study/ Documentation ➢ Computation of Income ➢ Latest assessment order and whether accepted by the assessee or has/ going to contest in further appeals ➢ Application of MAP and ongoing status ➢ Application of APA and ongoing status
2	Evidence of SA in Books of Account	Any invoice / debit note / JV raised on AE to give effect of PA
3	Evidence of any receipt of excess money	➢ Any communication of acceptance of SA by the AE ➢ Bank statement or any adjustment JV
4	Opinion taken	Documentation in support of any view / stand taken by assessee

RESPONSIBILITY AS TAX AUDITOR

S. No.	Audit procedure	Documentation
5	Calculation of Interest if excess money not repatriated within prescribed time	➢Relevant documentation of original transaction ➢Interest working by assessee ➢Certificate of Rate of Interest of SBI or LIBOR, as the case may be ➢JV or entry passed in BOA of assessee giving effect of this notional interest ➢ Interest in TAR to be reported till end of PY

AUDIT ISSUES

- 1. Whether amount of PA upto Rs. 1 crore or pertaining to AY earlier than AY 2017-18 to be reported? No.
- 2. Whether Interest to be disclosed till end of PY or till date of reporting TAR? End of PY.
- 3. Calculation of interest of reporting PY or earlier PY(s)? Yes.
- 4. What about reporting under Form 3CEB – of SA as well as of Notional Interest? Yes, to be reported.

LIMITATION ON INTEREST DEDUCTION SECTION 94B

INTRODUCTION

THIN CAPITALISATION → **Highly disproportionate DEBT: EQUITY** → Companies tend to borrow in **high-tax jurisdictions** to **avail higher tax deductions**

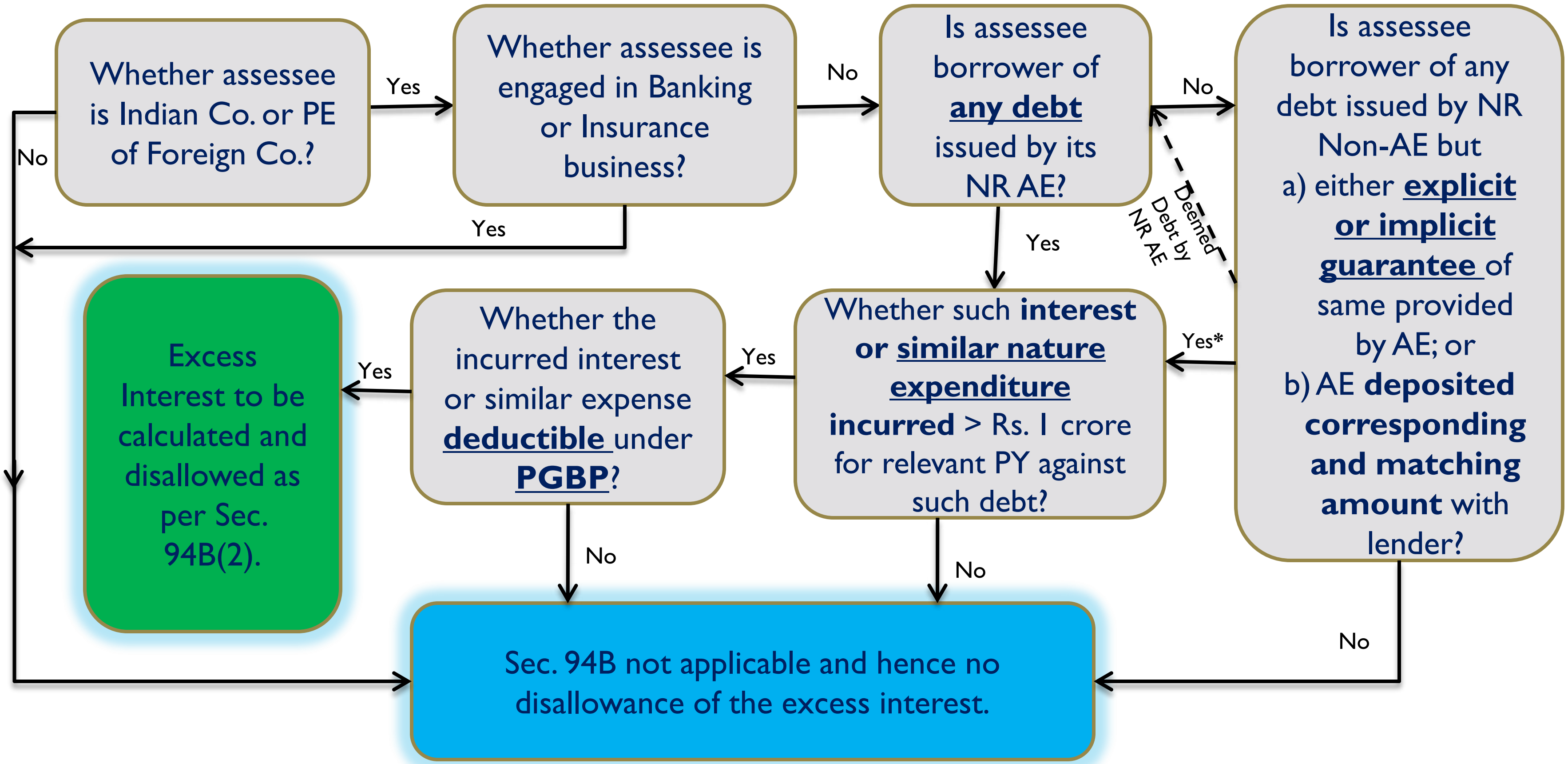
Why debt over equity?

- **No stamp duty** required for **infusion** of debt capital, unlike equity capital
- In most countries, **dividends** are subjected to **economic double taxation (DDT)**, whereas **interest is not**; on the contrary interest is **tax-effective**
- **Easy and tax effective repatriation** of borrowed funds as compared to capital infusion
- **Debt** is more **flexible**; it can be converted into equity, when required
- **Debt** can be **borrowed** in **foreign currency** to **avoid currency fluctuation risk**

INTRODUCTION

- Result of BEPS AP 4: Interest Deduction and Other Financial Payments to counter Thin Capitalisation
- MNEs strip the tax base by making capital structure of entities in higher jurisdiction aggressive w.r.t. debt-equity ratio
- AP 4 recommended Fixed Ratio Rule (FRR) which links entity's net interest deduction to its economic activity in the jurisdiction in which it operates.
- FRR limits deduction of **interest and expenditure similar to interest** of Entity to a set % of its EBITDA.
- Whether any rule could be recommended under which there could be restriction on Debt-Equity ratio?
  - Few countries across the globe having such laws but AP 4 do not recommend this as best practice approach. However, GAAR provisions consider but AE and Non-AEs all are covered.

APPLICABILITY – SEC 94B



*Such debt would be **deemed** to be issued by the AE.

POINTS TO PONDER

Not applicable on assessee other than Indian Company or PE of Foreign Company.

This section applies to NBFCs – as only companies carrying on Banking and Insurance businesses excluded.

Deposits corresponding and matching amount?

Deductible under PGBP [Sec. 14A, 36(1)(iii), 43B, 40(a), 40A(2), 92 {TP Addition}]

POINTS TO PONDER

Meaning of **interest** or **similar nature expenditure** to be derived from definition of **"debt"** u/s 94B(5)(ii) [definition having wide scope]:

"Debt" means any	Interest and other similar nature expenditure would be
Loan	Interest, processing fees
Financial Instrument	Discounts or Premium
Finance Lease	Finance cost component of Lease Rentals
Financial Derivatives	Discounts or Premium or Brokerage
any **arrangement** that gives rise to **interest, discounts or other finance charges**	Any Finance Charges (very wide scope)
that are **deductible** in the computation of income chargeable under the head **PGBP**	

Meaning of Interest to be derived from definition of **debt** instead of definition u/s 2(28A) of the Act.

POINTS TO PONDER

a. Whether LCs will be considered as debt?
b. Whether compulsorily convertible debentures which are hybrid instruments should be considered as debt?
c. Whether premium on option contracts (financial derivative) would be considered as 'other finance charges'?
d. Whether borrowing of real funds and availing of guarantee for borrowing could be classified in the same basket?

Lender and Borrower relationship must exist as deeming provisions to be read strictly.

POINTS TO PONDER

Explicit or Implicit Guarantee – Direct or Indirect*

Explicit has also not been defined in the Act but dictionary meaning of the same is:

Precisely and **clearly expressed** or readily observable; leaving nothing to implication (vocabulary.com);

Fully and clearly expressed or **demonstrated**; leaving nothing merely implied; unequivocal (dictionary.com)

Implicit has not been defined in the Act but dictionary meaning of the same is:

Capable of being recognised though **unexpressed**: **implied** (Advanced Law Lexicon by P. Ramanatha Aiyar 4th Edition);

Implied, rather than expressly stated; **implicit agreement** (Random House Compact unabridged dictionary, 2nd Edition)

*Note: **Contract of Guarantee** have been defined **u/s 126** of the Indian Contract Act, 1872. There must be **a "surety", a "principal debtor"** and a **"creditor".**

SYNOPSIS OF MADRAS HC WRIT

Constitutional validity **Proviso to Sec. 94B(1)** has been challenged before **Madras HC** by **Seimens Gamesa Renewable Power Pvt. Ltd.** ('petitioner') who pleaded to strike the Proviso on following contentions:

Deeming fiction created by the proviso to section 94B(1) read with Circular No. 2/2018 will increase tax burden when interest paid on a loan taken from a Non-AE resident lender with the guarantee of AE

Distinct and separate class of assessee differentiated with similarly placed companies merely on the basis of the involvement of an AE

Unreasonable and contrary to the provisions of the Article 14 and 19 of the Constitution:

- Other companies will enjoy a lesser tax burden than the petitioner, merely because of the existence of NR AE

Banks prefer guarantees from the AEs owing to the easy enforceability of debts in case of default

CBDT ought to have clarified that "Lender" would only mean a "non-resident lender"

CBDT ought to specify what would be included and excluded in the computation of EBITDA

EXCESS INTEREST COMPUTATION

On plain reading:

Excess Interest which is to be disallowed is lower of:

- Total interest paid or payable in excess of 30% of EBITDA; or
- Interest paid or payable to AE.

On basis of interpreting Circular 2/2018*

Interest deductible is lower of:

- 30% of EBITDA ; or
- Interest paid or payable to AE.

So remaining is excess interest which has to be disallowed.

*Issued on February 15, 2018.

EXCESS INTEREST COMPUTATION

Illustration		As per Plain Reading	Circular 2/2018
Interest to NR AE	A	80	80
Total Interest	B	130	130
EBITDA	C	200	200
30% of EBITDA	D	60	60
Total Interest in excess of 30% of EBITDA	E (B-D)	70	70
Excess Interest Disallowed (lower of E or A)	F	70	NA
Excess Interest Disallowed *	G (A-D)	NA	20
Interest Allowed (lower of D or A)*	H	10	60
Interest C/f	I	70	20

*Further, on reading of Clause 30B of TAR interpretation of Circular 2/2018 is providing better view. Would have been amended vide Finance Act, 2018 rather than through a Circular.

POINTS TO PONDER

Definition of EBITDA

- As per BOA or Tax Computation [Collins English Dictionary defines EBITDA as "the amount of profit that a person or company receives before interest, taxes, depreciation, and amortisation have been deducted".

Negative EBITDA

- No deduction of Interest to AE as always 30% would be less in such cases

Interest paid or payable

- Accrual concept irrespective of accounting method followed by other AE

Loan provided by a Bank to Group Entities on Guarantee of Parent Entity/ Any other group entity?

CARRY FORWARD OF EXCESS INTEREST

Excess Interest disallowed can be carried forward for **8 AYs succeeding** the AY in which such excess interest is disallowed and taken as deduction **subject to** the **limit u/s 94B(2)** in that relevant AY.

Illustration		As per Plain Reading	Circular 2/2018
Interest b/f	A	70	20
Interest to NR AE	B	80	80
Total Interest	C	100	100
EBITDA	D	300	300
30% of EBITDA	E	90	90
Total Interest in excess of 30% of EBITDA	F (C-E)	10	10
Excess Interest Disallowed (lower of F or B)	G	10	NA
Excess Interest Disallowed	H (A+B-E)	NA	10
Interest Allowed (lower of D or A)	I (A+B-G) or (A+B-H)	140	90
Interest C/f	J	10	10

AN ILLUSTRATION

- A Ltd. has borrowing of INR 100 crore from its overseas AE i.e. B Ltd. @ 14% p.a.
- Interest paid / payable to AE is INR 14 crore
- EBITDA of A Ltd. for year ended 31.03.2017 is 30 crores

Impact u/s 94B:

- Allowance u/s 94B = Lower of 14 crores and 30% of EBITDA i.e. 9 crores [(30%*30) = 9]
- Therefore, disallowance is 5 crores [(14 - 9) = 9]

During TP proceedings:

- Arm's length interest rate determined by TPO @ 11% and hence, made a transfer pricing adjustment of 3 crores [(14% - 11%) * 100 crores]

What would be the amount of interest allowed to be carried forward u/s 94B(4), INR 2 crores (as per TP Adjustment) or INR 5 crores (original c/f)

CLAUSE 30B* OF TAR

30 B(a) Whether the assessee has incurred expenditure during the previous year by way of interest or of similar nature exceeding one crore rupees as referred to in sub-section (1) of section 94B

(b)If yes, please furnish the following details

Select

In case this answer is **Yes**

*Inserted vide Notification No. 33/2018 dated 20/7/2018 effective from 20/8/2018.

	S.No.		Amount (in Rs.) of expenditure by way of interest or of similar nature incurred	Earnings before interest, tax, depreciation and amortization (EBITDA) during the previous year (in Rs.)	Amount (in Rs.) of expenditure by way of interest or of similar nature as per (i) above which exceeds 30% of EBITDA as per (ii) above.	Details of interest expenditure brought forward as per sub-section (4) of section 94B.		Details of interest expenditure carried forward as per sub-section (4) of section 94B:	
						Assessment Year	Amount (in Rs.)	Assessment Year	Amount (in Rs.)
	1					Select		Select	
2018-19	1		80	200	20		NIL	2018-19	20
2019-20	1		80	300	0	2018-19	20	2018-19	10

Add Delete

Notification No. 33/2018 dated 20.7.2018 effective from 20.8.2018.

RESPONSIBILITY AS TAX AUDITOR

S. No.	Audit procedure	Documentation
1	Identify any Interest Expenditure to NR AE of assessee	➢ TP Documentation ➢ Computation of Income ➢ Loan agreements and relevant document ➢RPT disclosure in FS of assessee and AEs
2	Identify any guarantee or any sort of support provided by AE to any lender of assessee	➢ Guarantee document ➢ Note of contingent liability in FS of AE ➢ Any documentation showing any sort of support provided by AE for raising funds for assessee from Non-AE
3	Scrutiny of expenses	➢ In depth scrutiny of expenses of assessee to identify any expenditure similar to interest from Expense Ledgers along with interest expense
4	Any "debt" obtained by assessee	➢ BOA of assessee as well as AE to be scrutinised from point of view of identifying debt under this section

RESPONSIBILITY AS TAX AUDITOR

S. No.	Audit procedure	Documentation to be verified
5	Opinion taken	Documentation in support of any view point
6	Verify Calculation of 30% of EBITDA	EBITDA to be taken from FS of assessee
7	Verify Interest brought forward	Relevant PY's TAR (if any) and ITR to be verified. However, for AY 2018-19 this amount would be nil in case of every assessee as this section applicable w.e.f. AY 2018-19.
8	Verify carried forward excess interest	Working of Client in this connection.

CASE STUDIES

CASE STUDY 1 – SEC 92CE

Safar Ltd. (Indian Co.), wholly owned subsidiary company of Tour Inc. (US Co.). Safar Ltd. have been entered into International transactions with 5 AEs:

AEs	International Transactions	Amount (INR in Crores)
Tour Inc.	Purchase of Raw Material	10
	Purchase of Finished Goods	45
	Interest payment @15% p.a. on loan of INR 200 crores	30
	Payment of Royalty	25
	Corporate Management Fees	10
Tourism UK	Purchase of Raw Material	30
Travels UAE	Purchase of Finished Goods	15
	Payment of Royalty	10
Trip Pty. Ltd., South Africa	Sale of Finished Goods	50
Traveller, Sweden	Purchase of spare parts	5

CASE STUDY 1 - SEC 92CE

TPO made TP additions (or PA) in computation of Safar Ltd. which were also accepted by Safar Ltd.:

a. TPO used SBI PLR of 13.70% to benchmark the interest payment to Tour Inc., thereby making addition of Rs. 2.6 crores where assessee benchmarked it by using CUP.
b. All other transactions were benchmarked using TNMM as MAM, where TPO made addition of Rs. 50 crores.

Hence, total TP additions or PA is Rs. 52.60 crores.

Further, the AEs did not repatriate the funds within 90 days of order of AO, and hence Safar Ltd. made SA in its books.

CASE STUDY 1 - SEC 92CE

- Issues

1. What will be allocation of PA amongst AEs, on SA made?
2. When PA made by TPO on interest paid to Tour Inc. and same considered as deemed advance:
   - Whether deemed advance can be adjusted against loan taken from Tour Inc.?
   - Impact of interest on such deemed advance, u/s 94B?
3. Implications when Trip Pty. Ltd., South Africa has exchange control provisions that make it difficult to repatriate the excess money to India?

CASE STUDY 1 - SEC 92CE

- Issues

4. If PA is accepted by the taxpayer and the AE in certain cases ceases to be an AE:
   - Whether SA can be made?
   - Whether the interest liability will cease, the moment an entity ceases to be the AE of the taxpayer?
5. Implications, if the AE's have already paid tax on such international transactions in their jurisdiction, which the Indian tax authorities consider as excess money?
6. Section 92CE defines SA to be an adjustment in the books of accounts of the assessee and the AE. Whether it would be within the control of the taxpayer to enforce recording of a primary adjustment in the books of accounts of the AE and whether it is within the jurisdiction of the Indian regulations to mandate such an action on part of the AE located outside India?

CASE STUDY 2 - SEC 94B

India Ltd. (Indian Co.) WOS of Douglas Ltd. (Isle of Man). Germany GmbH, German subsidiary of Douglas Ltd. India Ltd. borrowed fund from local bank, i.e. HDFS Bank. Germany GmbH, has provided letter of comfort to the Bank against borrowing by India Ltd. Relevant financial details of India Ltd.

Long-term Liabilities of India Ltd.	Amount in INR Crores
11% HDFS Bank Loan	1,000
10% Loan from Bharat Ltd. (WOS of India Ltd.)	500
7% Redeemable Preference Shares, Germany GmbH	300
8% Compulsorily Convertible Debentures, Douglas Ltd.	700

Statement of Profit and Loss	Amount in INR Crores
EBITDA	600
Less: Finance Costs	
a. Interest on loans	(216)
b. LC Charges	(20)
c. Premium on Option Contract	(25)
Less: Depreciation and amortization	39
Earnings before tax	300
Less: Provision for Tax	110
Earnings after tax	190

CASE STUDY 2 - SEC 94B

- Issues:

1. Amount of Interest to be disallowed as well as to be carried forwards u/s 94B?
2. What would be debt amount u/s 94B?
3. What amounts to be considered as interest or similar nature expenditure u/s 94B?
4. How to calculate EBITDA u/s 94B?
5. If TPO determines ALP of interest payment on compulsorily convertible debentures to its AE at 6%?

Thank You

CA. Chaitanya Maheshwari