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Undervaluation of shares and secondary adjustments: Next wave of transfer pricing litigation in India

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Formal transfer pricing (TP) regulations have been present in India for the past twelve years. During this period, India has witnessed a sharp increase in disputes involving TP issues, with the Indian Revenue adopting aggressive stands while conducting audits. The recently concluded eighth cycle of TP audit witnessed disputes on issues which were untouched in the initial seven audit cycles. One such dispute is adjustment on account of alleged undervaluation of shares issued by Indian subsidiary companies in favour of their foreign parent companies; and also imputing of notional interest in the hands of the Indian subsidiaries, by allegedly treating or re-characterising the deficit, as above, as loans purportedly advanced by the Indian subsidiaries to their foreign parent companies. In this article, we discuss both the above disputes in light of the Indian TP regulations and available international guidance.

The common set of facts permeating through the cases, as one might conceive by gleaning the media reports, are that the transfer pricing officer (TPO) alleged that the Indian Subsidiary (Sub Co) had purportedly issued shares to its overseas parent company (Parent Co) at a price less than the market price, i.e. as determined based upon a proper valuation. Represented through numbers, let us say that Sub Co had issued 100 shares to Parent Co at INR30 per share, i.e. for an amount of INR3,000, when, as per the TPO, the value of shares should have been say INR50 per share, or in other words, the TPO had observed that Sub Co should have issued the shares for an amount of INR5,000, instead of INR3,000.

The TPO supposedly proposed the following adjustments:
1. For the alleged shortfall in receipt for issue of shares, i.e. INR2,000 [100 x 20], a TP adjustment is made to the total income of Sub Co.

2. The TPO has further alleged that since Sub Co stood deprived of the aforesaid shortfall in value of shares, i.e. INR2,000; and the said sum actually resided within the coffers of Parent Co, the same partook of the character of a loan purportedly advanced by Sub Co in favour of Parent Co, on which he computed an arm's length rate of notional interest (say at10 percent) in the hands of Sub Co, amounting to INR200 [10 percent of 2,000].

Our views around the aforesaid adjustments are as follows :

Principal amount of INR2,000

a. Even if one were to admit, for the sake of argument, that the shares were issued at a price less than

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market value, the fact remains that the shortfall in the value of shares, i.e. INR2,000, would have only impacted the share capital of Sub Co; and not its profit and loss account or taxable income.

b. Section 92 of the Indian Income Tax Act (I T Act) has the mandate of adjusting the “income” arising from an “international transaction” with reference to the arm's length price (ALP).

c. Thus, when a transaction has no impact whatsoever on the “income” of a taxpayer, the provisions of TP cannot be applied to make any adjustment u/s 92 of the I T Act.

d. Therefore, no adjustment could be made, under any stretch of imagination, by invoking the provisions of TP (i.e. section 92 of the I T Act) in the hands of Sub Co, for any such alleged shortfall in the value of issue of shares in favour of its parent company, i.e. Parent Co.

Notional interest amounting to INR200

a. The TPO's attempt to make an adjustment for the notional interest amounting to INR200, under the aforesaid circumstances, is referred to as “secondary adjustment” in the parlance of TP.

b. A brief elucidation might be useful:

i. Let us say, an Indian entity (I Co) had purchased materials from its foreign associated enterprise (F Co) for INR500, when, the ALP of such purchase, as determined by the TPO & accepted by I Co, is INR400.

ii. The TPO makes an upward TP adjustment for the difference of INR100 [500 – 400] in the hands of I Co. This is referred to as a “primary adjustment” in TP, which is covered by Article 9 of tax treaties.

iii. However, the said sum of money, representing the primary adjustment, i.e. INR100, actually resides in the coffers of F Co; and not I Co, since I Co had paid INR500 to F Co as the price for the materials.

iv. Thus, unless F Co actually refunds the said sum of INR100 in favour of I Co, in which case, the financial accounts would match the TP adjustments, how would the Revenue Authorities treat the same for tax purposes?

v. Can the TPO automatically re-characterise the said sum of INR100 as dividend (in case F Co is a parent company of I Co) or loan (in case F Co is a subsidiary company of I Co); and charge either a dividend distribution tax or notional interest thereon, as the case may be ?

vi. The concept of re-characterisation of the principal TP adjustment (in the current example, INR100); and subjecting the same to tax consequences, is referred to as “secondary adjustment”.

c. Article 9 of tax treaties does not cover any such secondary adjustment. The OECD has clarified in its commentary on Article 9 of the model treaty convention that sovereign countries can opt for secondary adjustments, if permissible under their domestic tax laws.

d. Some countries have adopted the practice to apply secondary adjustments, on the backing of express provisions in their respective domestic tax laws, namely:

Canada

The Canadian Income Tax Act, empowers the Revenue to treat an upward TP adjustment as deemed dividend, however, no deemed dividend would arise if the non-resident is a controlled foreign affiliate for

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Canadian tax purposes. Secondary adjustments are undertaken regardless of whether the non-resident has an ownership interest in the Canadian company.

Korea

The Korean Income Tax Act permits the imposition of secondary adjustments, which are treated as deemed dividends, subject to withholding of taxes, as specified in the corporate tax law or applicable tax treaties. No secondary adjustment is made if the re-characterised amount is repatriated back to the Korean entity within three months of the primary TP adjustment.

South Africa

The South African Income Tax Act provides for secondary adjustment in the hands of the taxpayer, by re-characterising the primary adjustment as deemed loan given by the South African taxpayer, leading to imputation of notional interest. No secondary adjustment is made if the impugned amount is repatriated to the South African entity during the same financial year in which the primary adjustment is made.

EUJTPF

As per a report issued by European Union Joint Transfer Pricing Forum (EUJTPF) dated October 25, 2012 on "secondary adjustments" in TP, one notes that out of the twenty seven EU Member States, nine countries have legislation on "secondary adjustments": Austria, Bulgaria, Denmark, Germany, France, Luxemburg, Netherlands, Slovenia and Spain. EUJTPF has also provided for certain recommendations around secondary adjustments in the sense that Member States should refrain from inflicting upon "secondary adjustments", when they lead to double taxation.

Conclusion

The aforesaid elucidations clearly demonstrate that even globally, sovereign countries resort to carrying out "secondary adjustments" in TP only if there is an express and specific mandate provided in their respective domestic legislation. Countries do not undertake "secondary adjustments" in TP as a matter of practice, without the express blessing of their respective domestic legislation.

Since India does not have express or specific legislation for inflicting the "secondary adjustments" currently in vogue, the same could not have been resorted to as a matter of practice by the TPOs in India. Thus, such "secondary adjustments" made by TPOs are liable to be struck down, as lacking the necessary legislative mandate.

For More Information

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