India’s 2017-18 Budget includes key international tax proposals

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On February 1, 2017, India’s Finance Minister, Arun Jaitley, presented the country’s 2017-18 Budget, which contains several tax proposals in the area of international tax law, including the introduction of a new provision to provide for transfer pricing secondary adjustments and new thin capitalization rules. The Budget also contains much-needed clarity on the tax treatment of indirect transfers of assets and on the income tax provisions relating to fund management activity. These, along with other proposals, are summarized below.

Secondary adjustments

To align Indian transfer pricing provisions with the OECD Transfer Pricing Guidelines and international best practices, the Budget proposes to insert a new section in the Income Tax Act to provide that the taxpayer will need to make a secondary adjustment where the primary adjustment to the transfer price has been made in certain cases. The provision of a secondary adjustment is internationally recognized and is already part of the transfer pricing rules of many leading economies in the world (as noted in the Explanatory Memorandum published alongside the Budget). The new provision will only apply if the primary adjustment exceeds INR10m (about € 140,500) and the excess money attributable to the adjustment is not brought to India within the prescribed time.

According to the new rule, the taxpayer will be required to carry out a secondary adjustment where the primary adjustment to a transfer price is made *suo moto* by the taxpayer in his return of income; or is determined by an advance pricing agreement entered into by the taxpayer; or is made as per the Indian safe harbor rules; among other cases. Where as a result of a primary adjustment to the transfer price, there is an increase in the total income or reduction in the loss of the taxpayer, the excess money which is available with its associated enterprise, (if not repatriated to India within the prescribed time) shall be deemed to be an advance made by the taxpayer to such associated enterprise and the interest on such advance shall be computed as the income of the taxpayer. The new provision will be effective from April 1, 2018 and will apply from the 2018-19 assessment year.

Interest deductions

In line with the OECD's recommendation under Action 4 of the BEPS project, the Budget proposes to amend the Indian Income Tax Act to provide that interest paid by an Indian company or a permanent establishment of a foreign company to its associated enterprises in excess of thirty percent of EBITDA shall not be allowed as deduction in computing its taxable profit. It is also proposed to allow carry forward and set off of the interest so disallowed for eight assessment years. The proposal is aimed at countering cross-border shifting of profit through excessive interest payments and protecting India's tax base (it needs to be seen if the measure would impact third-party lenders given the expansive definition of related parties under the Income Tax Act).

The measure will be applicable to an Indian company (or a permanent establishment of a foreign company) being the borrower who pays interest in respect of any form of debt issued to a non-resident or to a permanent establishment of a non-resident and who is an associated enterprise of the borrower. The debt will be deemed to be treated as issued by an associated enterprise where it provides an implicit or explicit guarantee to the lender or deposits a corresponding and matching amount of funds with the lender. To target only large interest payments, the Budget proposes to provide for a threshold interest expenditure of INR10m.

In line with the BEPS recommendations, the Budget proposes to exclude banks and insurance businesses from the ambit of the new measure keeping in view the special nature of these businesses. The new measure will take effect from April 1, 2018, and will apply from the 2018-19 assessment year.

Offshore funds

Section 9A of the Income Tax Act provides that in the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India of the said fund. The benefit under section 9A is available only upon fulfillment of certain conditions stipulated in that section, including the requirement for an offshore fund to maintain a corpus of INR1bn. The Budget relaxes this condition and proposes (in view of representations received from various stakeholders) to do away with the requirement to maintain a minimum fund size in the year in which the fund is being wound up. The proposal is of course welcome but unfortunately will not adequately address the concerns of the fund management industry as long as other burdensome conditions, such that the fund must have a minimum of 25 percent of independent members (that is, not related parties), continue to remain in section 9A.

Indirect transfers

The indirect transfer tax provisions contained in section 9(1)(i) of the Income Tax Act provides that all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India shall be deemed to accrue or arise in India. The 2012 Finance Act added an Explanation to clarify that an asset or capital asset, being any share or interest in a company or an entity registered or incorporated outside India, shall be deemed to be situated in India, if the share or interest derives (directly or indirectly) its value substantially from the assets located in India.

The indirect transfer tax provisions, which were introduced in the wake of the Vodafone case to expand the source rule on taxation of capital gains, have long caused a great deal of uncertainty in so far as taxation of fund management activity is concerned (particularly, concerns relating to multiple taxation and burdensome compliance requirements). In a welcome move, the Budget proposes to exempt Category I and II foreign portfolio investors from the indirect transfer provisions and clarifies that the provisions will not apply in case of redemption of shares or interests outside India as a result of or arising out of redemption or sale of investment in India which is chargeable to tax in India. It is imperative to note that the exemption does not extend to Category III foreign portfolio investors.

Other proposals

Also included in the Budget is a proposal to restrict the scope of domestic transfer pricing only if one of the entities involved in a related-party transaction enjoys a specified profit-linked deduction (with a view to reducing taxpayer compliance burden). Finally, the Budget proposes to amend sections 90 and 90A of the Income Tax Act to provide that where any "term" used in a tax treaty is defined under the treaty, the said term shall be assigned the meaning as provided in the treaty, whereas if the term is not defined in the treaty, but is defined in the Income Tax Act, then that term shall be assigned the meaning as defined in the Income Tax Act.