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Recent Issues Involved in Determination of Associated Enterprises under the Indian Transfer Pricing Regime

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ABSTRACT

Section 92A (1) and (2) of the Income Tax Act, 1961 prescribe the conditions for determination of an Associated Enterprise (AE). On effectuating the said conditions an enterprise can be said to be an AE and transfer pricing regime of the Act can be attracted thereupon. A plain reading of Section 92A(1) provides two conditions, on satisfying which the determination of an AE can be effectuated. Clause (a) of the section says that if any enterprise participates directly or indirectly in the management, control, or capital of the other enterprise then such enterprise shall be an associated enterprise. Clause (b) says that if any one or more person participating in the decision and control of the main enterprise, also participates in the control of the other enterprise then the other enterprise shall be said to be the associated enterprise. Subsection (2) lays down the criteria under which direct or indirect control, as referred under section 92A(1), can be ascertained. There have been instances where one subsection overlaps another. Mechanically, one provision outgrows another rendering its affectability otiose. The interpretation of both the subsection has become a debatable matter in recent times. Though this article, the author proposes to bring out the issues involved in determination of an AE. The author has highlighted the issues in interpretation of both the subsections and how one overlaps the other. Several judgments, circular and memorandum have been relied upon to address the issue effectively.

Keywords: *Enterprise, Associated Enterprise, Section 92A, Interpretation, Taxation*

I. INTRODUCTION

Section 92A (1) and (2) of the Income Tax Act, 1961 prescribe the conditions for determination of an Associated Enterprise (AE). On effectuating the said conditions an enterprise can be said to be an AE and transfer pricing regime of the Act can be attracted thereupon.

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Section 92A(1) provides two conditions, on satisfying which the determination of the enterprise can be made. Clause (a) of the section says that if any enterprise participates directly or indirectly in the management, control, or capital of the other enterprise then such enterprise shall be an associated enterprise. Here, control through an intermediary too, is considered as direct or indirect control. Clause (b) of the same section provides vertical structure of control. It says that if any one or more person participating in the decision and control of the main enterprise, also participates in the control of the other enterprise then the other enterprise shall be said to be the associated enterprise. Such control can be exercised directly, indirectly or through one or more intermediaries. Therefore, for the purpose of determination of an enterprise, to be an associated enterprise, any of the abovementioned conditions shall be fulfilled. The relevant exctract of the same section is:

(1) For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, "associated enterprise", in relation to another enterprise, means an enterprise—

(a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or

(b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.[2]

Now, let us look into the provision of Section 92A(2). This section mainly lays down the criteria under which direct or indirect control, as referred under section 92A(1), can be ascertained. It starts with the words, “for the purposes of subsection (1)”. This subsection is a deeming fiction, and it can be applied only if the specific facts of the case attract any of the conditions laid down under this section. This section consists of clause (a) to (m) and provides fourteen conditions. The relevant extract of the said section is reproduced below:

(2) For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,

(a) one enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; or

(b) any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or

[2] Income Tax Act, 1961

(c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or

(d) one enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or

(e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or

(f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or

(g) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or

(h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or

(i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or

(j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or

(k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or

(l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or

(m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.[3]

II. ISSUES

On perusal of both the subsections, one can arrive at situations where, after satisfying the specific provision of Section 92A(2), an enterprise can fall short of satisfying the provision of Section 92A(1) and vice versa. The most significant factor for determination of the same are the facts that vary from case to case. Now, the most important issue in determination of an AE is whether an enterprise be an AE if it meets the conditions provided only under Section 92A(1) and not under 92A(2).

As per the general principles of interpretation an enterprise shall be an AE if it fulfills any of the conditions as provided under section 92A(1) of the Act and not under section 92A(2). It is pertinent to note that the provision of Section 92A(1) has a wide scope and subsection (2) merely provides clarity on the same. Further, subsection (2) is subject to Subsection (1). Mechanically, the provision of 92A(1) will get attracted if any of the conditions provided under section 92A(2) are met but the same cannot be done if the facts are vice versa. The issue that arises here is whether an enterprise be an AE if none of the conditions under section 92A(2) are met but there is de facto or de jure participation in control, management or capital under 92A(1).

It has been quoted in the Memorandum to Finance Bill 2002 that, "It is proposed to amend sub-section (2) of the said section to clarify that the mere fact of participation by one enterprise in the management or control or capital of the other enterprise, or the participation of one or more persons in the management or control or capital of both the enterprises shall not make them associated enterprises, unless the criteria specified in sub-section (2) are fulfilled". This facet is apparent from the CBDT circular no. 8 of 2008 wherein it has been quoted that "the Finance Act, 2002, has amended sub section (2) of section 92A to clarify that where any of the criterion specified in sub section (2) is fulfilled, two enterprises shall be deemed to be associated enterprises". This circular clearly implies that the provisions of Section 92A(1) are subject to the conditions provided under 92A(2).[4] Prior to the amendment made under Finance Act, 2002 the provisions of section 92A(2) were the same except for the words 'for the purposes of subsection (1)'. Therefore, it can be said that before amendment, both the sub sections could be read independently. Any enterprise that satisfied any of the

[3] supra
[4] CBDT Circular No. 8 of 2008

condition provided under subsection (1) and/or (2) could be said to be an AE. But after the amendment, the Memorandum and Circular have provided better anchorage to subsection (2) over subsection (1).

It is elementary that the circulars issued by the CBDT, in exercise of the powers under section 119 of the Act bind all authorities. The relevant extract of Section 119(1) says, "The Board may, from time to time, issue such orders, instructions and directions to other income-tax authorities as it may deem fit for the proper administration of this Act, and such authorities and all other persons employed in the execution of this Act shall observe and follow such orders, instructions and directions of the Board".

It has also been held by Hon'ble Supreme Court in the case of UCO Bank Vs CIT[5], that, "the relevant circulars of the Board cannot be ignored. The question is not whether a circular can override or detract from the provisions of the Act; the question is whether the circular seeks to mitigate the rigor of a particular section for the benefit of the assessee in certain specified circumstances. So long as such a circular is in force, it would be binding on the departmental authorities in view of the provisions of section 119 to ensure a uniform and proper administration and application of the Act".

The validity of this rule was also recognised in Baleshwar Bagarti v. Bhagirathi Dass where Mookerjee, J. stated the rule in these terms: "It is a well-settled principle of interpretation that courts in construing a statute will give much weight to the interpretation put upon it, at the time of its enactment and since, by those whose duty it has been to construe, execute and apply it."

Circulars beneficial to the assessee which tone down the rigor of the law and are issued in exercise of the statutory powers under Section 119 are binding on the authorities in the administration of the Act. The benefit of such circulars is admissible to the assessee even though the circulars might have departed from the strict tenor of the statutory provision and mitigated the rigor of the law. The same was held in In Keshavji Ravji and Co. v. Commissioner of Income-Tax.[6]

The Bench, in K.P. Varghese v. Income Tax Officer, Ernakulam and Ors.[7] has held that circulars of Central Board of Direct Taxes are legally binding on the Revenue and this binding character attaches to the circulars even if they are found not in accordance with the correct interpretation of the section and they depart or deviate from such construction.

[5] [(1999) 237 ITR 889]
[6] [1990 (183) ITR 1]
[7] [1981 (4) SCC 173]

Further, in Navnitlal C. Jhaveri v. RR. Sen[8] circulars issued by the Central Board of Direct Taxes under Section 119 of the Act are binding on all officers and persons employed in the execution of the Act, even if they deviate from the provisions of the Act.

Also the Hon'ble Apex Court in Principal Commissioner of Income Tax v Veer Gems[9] has quoted that, "What is thus clear that as long as the provisions of one of the clauses in Section 92A(2) are not satisfied, even if an enterprise has a de facto participation capital, management or control over the other enterprises, the two enterprises cannot be said to be associated enterprises".

The Tribunal, Kaybee Pvt Ltd vs. ITO[10], has also reversed its view on the previous rulings involving the same parties. It says that the, "Once we hold that Section 92A(1) cannot be applied on standalone basis, and has to be essentially considered in conjunction of Section 92A(2) – only when it satisfies at least one of the conditions set out therein, it is clear that the relationship between the assessee company and its KE-S cannot be said to be that of the associated enterprises. The case of the revenue must, therefore, fail on this test".

Therefore, from the perusal of above mentioned memorandum, circular and judgements, it can be concluded that an enterprise can be an AE if any of conditions under Section 92A(2) are met. Mere participation in control, management or capital of the enterprise, as provided under Section 92A(1) is not sufficient. This hereby renders subsection (1) to be subjective to subsection (2). As all the judgements indicate that the conditions provided under section 92A(2) prevails over the provision of Section 92A(1). Even if the conditions under section 92A(1) are met, one has to determine the status of an AE in accordance with the conditions of 92A(2). It is prudent from the above discussions that, for the purposes of construing an AE, relevance has be given only to section 92A(2), which establishes that Section 92A(1) and Section 92A(2) being read together for the purposes of harmonious construction is a mere fallacy.

A contradictory approach to the same can be taken by relying on the following judgements.

The Bangalore Tribunal in Principal Commissioner of Income Tax-5 vs M/S Page Industries Ltd[11] decided in favor of the assessee quoting, "If we were to hold that there is a relationship of AE, once the requirements of subsection (2) are fulfilled, then the provisions of sub-section (1) renders otiose or superfluous. Now, it is well settled canon interpretation of

[8] [1965 AIR 1375]
[9] [(2018) 256 TAXMAN 298 (SC)]
[10] [ITA No. 2165/Mum/15]
[11] [IT(TP)A No.163/Bang/2015]

statutes that while interpreting the taxing statute, construction shall not be adopted which renders particular provision otiose. When interpreting a provision in a taxing statute, a construction, which would preserve the purpose of the provision, must be adopted". Further, the Hon'ble Karnataka HC, in deciding the same issue in appeal, upheld the decision of the Tribunal. It was held by the Hon'ble Court that if the provisions of sub-Sections (1) and (2) are read independently, then one of the provisions would be rendered otiose which is impermissible in law in view of the well settled rule of statutory limitation. Therefore, the conditions under both the subsections must be complied with.

Further, it has been observed in State of Tamil Nadu v. M.K. Kandaswami[12] that in interpreting a provision, a construction which would defeat its purpose and, in effect, obliterate it from the statute book should be eschewed. If more than one construction is possible, that which preserves its workability and efficacy is to be preferred to the one which would render it otiose or sterile. In that view of the matter, courts should not adopt construction which would upset or even impair the purpose in introducing a particular provision in the statute. The same was held in Calcutta Jute Manufacturing Co. v. CTO.[13]

III. CONCLUSION

Therefore, it can be said that interpretation of Section 92A(1) and (2) is a debatable issue that can be relied on the facts of the case. As far as, the rules of interpretation is concerned, a harmonious construction shall be done. But the memorandum to the Finance Bill, 2002 and CBDT Circular clearly stipulate that the Section 92A(2) prevails over Section 92A(1). Various judgements too, are pronounced whereby it has been held that both the subsections shall be read together but the provision of subsection (2) has been a decisive factor in determination of most of recent issues involving AE, rendering the relevance of subsection (1) to be futile. Therefore, further clarity is required on the same.

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[12] [(1975) 36 STC 191, 198 (SC)]
[13] [(1997) 106 STC 433, 439 (SC)]