

## Associated Enterprises U/S 92A – A Revisit



*Understanding the definition of “Associated Enterprise” is a pre-requisite for the understanding of Transfer Pricing. Transfer Pricing is the setting of the price for goods and services sold between controlled (or related) legal entities within an enterprise. Legal entities considered under the control of a single corporation include branches and companies that are wholly or majority owned ultimately by the parent corporation. Transfer price should match with either what the seller would charge an independent, arm's length customer, or what the buyer would pay an independent, arm's length supplier. While unrealistic transfer prices do not affect the overall enterprise directly, they become a concern for the taxing authorities when transfer pricing is used to lower profits in a division of an enterprise located in a country that levies high income taxes and raise profits in a country that is a tax haven that levies no (or low) income taxes. Transfer pricing is the major tool for corporate tax avoidance also referred to as base erosion and profit shifting (BEPS),<sup>1</sup> Section 2(12) of the Central Goods and Services Tax Act, 2017 states the term “associated enterprises” shall have the same meaning as assigned to it in Section 92A of the Income Tax Act, 1961. The article attempts to revisit the topic and give a better understanding of the term “Associated Enterprise”. Read on to know more...*



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### Meaning of the term “Enterprise”

As per Section 92F(iii) the term “Enterprise” means:

- a person (including a permanent establishment of such person)
- who is, or has been, or is proposed to be,
- engaged in any activity, relating to the production, storage, supply, distribution, acquisition or

<sup>1</sup> Wikipedia- Definition of Transfer Pricing

- control of articles or goods, or 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 the provision of services of any kind,
- [or in carrying out any work in pursuance of a contract,]
- or in investment, or providing loan
- or in the business of acquiring, holding, underwriting
- or dealing with shares, debentures or other securities of any other body corporate, whether such activity
- or business is carried on, directly
- or through one or more of its units
- or divisions or subsidiaries, or whether such unit
- or division or subsidiary is located at the same place where the enterprise is located or at a different place or places.

Thus, the definition is exhaustive covering a wide extensive coverage.

## Meaning of “Associated Enterprise”:

### Section 92A(1)

#### Sub-clause (a)

*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—*

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

#### Interpretation of the terms used in Sub-clause (a) above:

- **Participates:** The word used is “participates”. This word is not defined in the Act. Hence, we have to construe the general dictionary meaning viz., contributes, partakes, joins, shares etc. Participation can either be direct or indirect or through one or more intermediaries.

Example – There are 3 enterprises A, B and C and a person Mr. D. The following situations arise:

A participates directly - Direct participation in B;

A participates in C, which in turn participates in B; - Indirect participation

A nominates Mr. D who participates in C; - participation through intermediaries.

As we see, that the difference between indirect participation and participation through intermediaries is very thin and debatable. The two terms are often used interchangeably.

- **Management:** Management is the administration of an organisation, whether it be a business, a not-for-profit organisation, or government body. Management includes the activities of setting the strategy of an organisation and coordinating the efforts of its employees or volunteers to accomplish its objectives through the application of available resources, such as financial, natural, technological, and human resources.

- **Control:** Dictionary meaning – The direct or indirect power to direct the management and policies of a person or entity whether through ownership of voting securities by contracts or otherwise; the power or authority to manage, direct or oversee;

Definition as defined in Accounting Standard Rules 2012.

Paragraph 5.1 of Accounting Standard 21 defines control as under:

- (a) the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or
- (b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

Notwithstanding the fact that the above definition was framed for the purpose of Accounting Standard–21 dealing with Consolidation of Accounts, the crux of the definition can be adopted for the purpose of Section 92A.

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A still more comprehensive definition of 'Control' is available in Ind Accounting Standards – 110. Paragraph 7 of the above standard defines as under:

Investor controls an investee if and only if the investor has all the following:

- (i) power over the investee
- (ii) exposure, or rights, to variable returns from its involvement with the investee
- (iii) the ability to use its power over the investee to affect the amount of investors' returns

Again, as explained in the earlier paragraphs, though the definition as above is specifically defined for the purpose of consolidation of accounts, the ratio of the definition is equally applicable for the determination of control u/s 92A.

- **Capital:** Guidance note on terms used in financial statements issued by Institute of Chartered Accountants of India defines *Capital* as the amount invested in the enterprise by its owners. In the context of corporates, it is the paid-up equity capital.

Definition of *Capital* assumes importance inasmuch, in case of Limited Liability Partnerships, the participation in capital shall be the deciding factor for declaring an enterprise as associated.

While Section 92A(1)(a) uses the word 'participates,' it does not specify any threshold limit. Thus, a plain reading of Section 92A(1)(a) indicates that even a small percentage of holding of capital (i.e., 1% or even less) may indicate that the two enterprises are associated.

However, Section 92A(1)(a) shall not be read in isolation. It shall be read together with 92A(2)(a) which states the minimum threshold limit of 26% holding. Now the question arises whether Section 92A(1)(a) overrides Section 92A(2)(a) or *vice versa*.

Section 92A(1)(a) is a general provision inasmuch it indicates the participation not only in capital but also in control and management. In contrast, Section 92A(2)(a) is a special provision dealing with the holding of shares. Thus applying the principle of "*generalia specialibus non-derogant*" i.e., special provisions override the general provisions, it can be inferred that Section 92A(2)(a) overrides Section 92A(1)(a).

Also, invoking 92A(1)(a) will make Section 92A(2)(a) redundant and *vice versa*. Thus as per the interpretation of statutes, if invoking a

provision makes other provision(s) redundant, the same shall not be invoked. ("*ut res magis valeat quam pereat*")

Thus, it can be inferred that Section 92A(2)(a) overrides the provisions of Section 92A(1)(a). Section 92A(1)(a) is redundant as far as the reference to the capital is concerned.

## Section 92A(1)

### Sub-clause (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.***

The basic difference between clauses (a) and (b) is that, clause (a) is dealing with persons having participation in management, control or capital in other enterprise. But clause (b) deals with situations where two enterprises become associated if common persons participate in more than one enterprise.

For example, if two enterprises become associated by virtue of holding and subsidiary relationships, the subsidiaries become associated by virtue of this sub-Section.

Thus, Section 92A(1)(a) deals with linear or vertical relationships and Section 92A(1)(b) deals with lateral or horizontal relationships.

Before we go further into Section 92A(2), let us see the observations of the Tribunal in the case of *Diaego India P Ltd. vs. Dy. CIT [2011] 13 Taxmann. com 62 (Mumbai)*, which are as under:

- 1) Associated enterprises are primarily defined under Section 92A(1)(a).
- 2) Scope of this definition is further expanded by Section 92A(1)(b) by including group concerns.
- 3) True test of associated enterprise is the existence of control of one over the other or control of two or more enterprises by a common interest.
- 4) Such de-control shall exist in decision making process.
- 5) Provisions of Section 92A(2) are the practical illustrations of the situations mentioned in Section 92A(1)(a) but equally applicable to Section 92A(1)(b) also.
- 6) Section 92A(2) illustrates the manner in which such *de-facto* control exists.

## Section 92A(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,—**

### **Sub-clause (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**

This is an obvious inference to Section 92A(1)(a) specifying the threshold limit of the holding shares for the purpose of treating it as an associated enterprise.

### **Sub-clause (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**

This is similar to the earlier provision barring the fact that it pertains to the holding of 26% of more shares in more than one enterprise.

### **Sub-clause (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**

Loan includes all forms of loans. This clause stipulates that the total loan advanced by one enterprise to other enterprise, if it equals to or exceeds 51% of the book value of the total assets, such enterprises become *associated*. It is the book value of the assets that shall be taken into consideration. In other words, the book value of the assets as per the latest audited balance sheet shall be the criterion. Market fluctuations or market value of the assets shall not be taken unless the assets are revalued.

This clause stipulates that (Loans obtained/Book value of assets)\*100, if 51% or more, such enterprises shall become associated.

Loans obtained means and include all loans obtained includes secured, unsecured and also debentures.

Assets – are defined as resource, arising of past activities or events, owned by the enterprise and future economic benefits flow to the organisation. Both tangible and intangible assets qualify under this definition.

Whether accumulated losses, preliminary expenses qualify as assets?

Accumulated losses are resource (though negative), arising out of past activities, owned by the enterprise and future economic benefits (reduction in taxes due to set off of losses) flow to the organisation. Thus, it qualifies to be an asset. However, the reduction in taxes due to set-off is not a flow of economic benefits. Losses to an organisation are erosion of capital and set-off of losses is another form of replenishment by the government, of the eroded capital of the organisation.

Similarly, preliminary expenses are in the form of deferred revenue expenditure to be amortised over a period of time.

### **Sub-clause (d)**

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

This clause is direct. When an enterprise guarantees 10% or more of the total borrowings of the other enterprise, such enterprises are said to be *associated*.

### **Sub-clause (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**

The distinction is made between directors and executive directors, in case of corporates and members of the governing board and executive members, in case of other enterprise, of the governing board. In case of corporates, non-executive directors and executive directors are distinguished.

For non-executive directors, it is more than half of the total number in the board is the criterion. For executive directors, even the appointment of one person shall become the criterion.

Possible reasons for the distinction between executive directors and non-executive directors are that whereas non-executive directors are generally based on the total shareholding capacity and more than half of the directors being appointed by an enterprise means a *de-facto* control over the other enterprise. On the other hand, appointment of non-executive directors

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means the enterprise holding a say in the management of the day-to-day affairs of the other enterprise. Here, directors means with reference to the companies and members means with reference to other than companies.

## **Sub-clause (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***

It is the same as that sub-clause (e) except that this clause pertains to more than two enterprises.

## **Sub-clause (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, licenses, 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***

This provision would be applicable even in case, it holds good at any time during the previous year. In other words, the existence of conditions throughout the year or at the Balance Sheet date is not a pre-requisite. Even if it exists on a single day in the relevant previous year, the enterprises would become associated enterprises. Again the provision would be applicable if and only if the enterprise is wholly dependent on the intangible assets of the other enterprise.

Thus, five conditions exist:

- 1) One enterprise should be dependent on the assets of the other enterprise.
- 2) Dependence should be whole i.e., 100%.
- 3) Assets here refers to intangible assets.
- 4) One enterprise shall be the owner of such assets.
- 5) Other enterprise has exclusive rights.

This sub-Section does not talk about tangible fixed assets.

## **Sub-clause (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***

Following conditions exist here:

- 1) At least 90% of the raw materials and consumables are supplied by the other enterprise; or
- 2) At least 90% of the raw materials and consumables are supplied by the person specified by the other enterprise; and
- 3) Prices and other conditions relating to the supply are influenced by such other enterprise.

The conditions (1) and (2) are applicable only with respect to raw materials and consumables. Again, conditions (1) and (2) are alternative. Condition (1) and Condition(3) as well as Condition (2) and Condition (3) are cumulative. In other words, if condition (1) or condition (2) are fulfilled but condition (3) is not fulfilled, it seems that the enterprises are not *associated enterprises*.

In other words, mere supply of 90% of raw materials and consumables will not make the enterprises associated. Similarly, mere control of prices and other conditions relating to the supply cannot make the enterprises associated. Thus, supply of raw materials and consumables at the prevailing market rates shall not attract this sub-clause.

## **Sub-clause (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***

The above clause consists of following:

- 1) There should be a sale.
- 2) Sale shall be to other enterprise or a person specified by the other enterprise.
- 3) The goods sold shall be manufactured or processed by the first enterprise.
- 4) Prices and other conditions are influenced by the other enterprise.

In other words, mere sale of goods or articles manufactured or traded will not make the enterprises associated. Similarly, mere control of prices and other conditions relating to the supply cannot make the enterprises associated. Thus, sale of goods or articles manufactured or traded at the prevailing market rates shall not attract this sub-clause.

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## Sub-clause (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

Conditions are:

First enterprise	Second enterprise	Inference
Controlled by individual	Controlled by individual	Associated enterprise
Controlled by individual	Controlled by the relative of that individual	Associated enterprise
Controlled by individual	Controlled by individual and his relative	Associated enterprise
Controlled by individual	Controlled by the individual and his relatives	Associated enterprise
Controlled by Relatives of an individual	Controlled by the same relatives of the individual	Not an associated enterprise
Controlled by individual and his relative(s)	Controlled by individual and his relative(s) – same set	Not an associated enterprise

Relative means the husband, wife, brother, sister, any linear ascendant or descendant of an individual as defined under Section 2(41) of the Income Tax Act, 1961.

## Sub-clause (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

First enterprise	Second enterprise	Inference
Controlled by HUF	Controlled by member of HUF or relative of such member of HUF or jointly by the member of HUF and his relative	Associated enterprise

## Sub-clause (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

Conditions are:

- 1) One enterprise shall be a firm or Association of Persons (AOP) or Body of Individuals (BOI);
- 2) Other enterprise shall be of any type; and
- 3) Other enterprise shall hold not less than 10% or more in such firm/AOP/BOI

If the above conditions are fulfilled, then the two enterprises are *deemed to be associate enterprises*.

All the conditions enlisted above are cumulative.

## Sub-clause (m)

there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

This is a residuary clause. CBDT is empowered to notify any other relationships or mutual interest not specified so far, to be the criteria for the declaration of two or more associate enterprises.

## Applicability in CGST Act, 2017

This is also a pre-requisite for the understanding of the application of provisions of the CGST Act, 2017.

The definition of *associated enterprises* is important in view of the fact that, the Central Goods and Services Act, 2017 takes the meaning of "Associated Enterprises" from Section 92A of the Income Tax Act, 1961.

Second Proviso to Section 13(3)(b) of the Central Goods and Services Tax Act, 2017 provides that in case of supply by associated enterprises, where the supplier of service is located outside India, the time of supply shall be the date of entry in the books of account of the recipient of supply or the date of payment, whichever is earlier.

## Concluding remarks:

An in-depth study of the definition of "*associated enterprises*" is the pre-requisite for understanding the application of the various provisions relating to the transfer pricing, both international as well as domestic. ■