
ASSOCIATED ENTERPRISE – THE HEART OF INTERNATIONAL TAXATION AND TRANSFER PRICING

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ABSTRACT

Transfer pricing is the setting of the price for goods and services sold between controlled or related entities within an enterprise.¹ Section 92A to 92F of the Income Tax Act, 1961 deals with transfer pricing. Income arising from international transaction, i.e., a transaction between two or more associated enterprises, either or both of whom are non-residents, is a precondition for the application of these provisions.² Thus, it is necessary to clearly identify “associated enterprises” in international transactions. This article discusses the concept of associated enterprise under section 92A, the interplay between clauses (1) and (2) with supporting case laws and illustrations.

¹ ICSI, Guide to Transfer Pricing, available at https://www.icsi.edu/media/webmodules/publications/Guide_to_Transfer_Pricing.pdf (Last accessed on 26th March, 2022)

² Dr. Vinod K Singhania, Dr. Kapil Singhania, Taxman’s Direct Taxes Law and Practice, 58th Edition, pp.1323

Associated Enterprises – Definition

In the light of the definition given under section 92A (1), two or more enterprises can be called as ‘associated enterprises’ either under linear structure or lateral structure.³ Firstly, is the linear structure where one enterprise participates directly or indirectly or through one or more intermediaries in the management, control or capital of the other enterprise. For example, if a foreign company F1(US) owns 100% capital of an Indian company X, then F1 and X associated enterprises through **direct participation**. If F1 owns 100% of M (China) which in turn owns 100% of X, then F1 and X are associated enterprises through **indirect participation** where M is the intermediary. Secondly, is lateral structure, where if one or more persons who participate, directly or indirectly or through intermediaries, in the management/control/capital of one enterprise, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management /control/capital of the other enterprise. For example, two persons/enterprises A and B collectively own 100% of the capital of foreign company, F1 and Indian Company X, then F1 and X are associated enterprises.

Deemed Associated Enterprises

In *Pr CIT vs. M/s Veer Gems*,⁴ the Gujrat High court held that section 92(A)(1) is only a principal basis for examining whether or not the enterprises are AEs. Section 92(A)(2) provides illustrations of the cases in which such an enterprise participates in the management capital or control of another enterprise. Further, a mere participation in management, control or capital cannot be a sufficient criterion to establish association between two or more enterprises. The definition under section 92A (1) is vague as it does not quantify the level of participation by one enterprise in the management, control or capital of other enterprise(s) beyond which they shall become associated enterprises. In order to establish the relationship of AE, the form of participation in management, control or capital should be recognized by Section 92A (2). Thus, section 92A (2) governs the operation of Section 92A (1) by controlling the definition of participation in the management or capital or control by one of the enterprises in the other.⁵ Unless one of the clauses of Section 92(A)(2) are attracted, the enterprises cannot be regarded as AEs even if one of them has de facto participation in capital or management or control of the other. Where any of the criteria specified in Section 92A (2) is fulfilled, the two enterprises

³ Unknown, Law relating to Transfer pricing - Who are “Associated Enterprises” (AEs)? pp.39-53, Unknown

⁴ [ITA No. 1514/Ahd/2012 C.O. Np.184]

⁵ Orchid Pharma Ltd. v. Dy. CIT, [2016] 76 taxmann.com 63

shall be deemed to be AEs.⁶ In *M/s Page Industries Ltd. v. DCIT (ITAT)*⁷, it was held that even though the assessee satisfied the provisions of S.92A(2)(g), it failed to satisfy the criteria mentioned under section 92(A)(1). Hence, the assessee cannot be treated as an Associate Enterprise. Similar views were held in *Sanchez Capital Services(P) Ltd. v. ITO*⁸ and *ITO v. Alumeco India Extrusion Ltd.*⁹

Types of Associated Enterprises

Formation of Associated enterprises can be grouped into three baskets depending on the nature of participation i.e., participation in either capital, management or control.

I. Participation in Capital

Participation in capital can be through contribution of equity capital or loan capital or by guaranteeing borrowings of one enterprise by the other. In this way, one enterprise has de facto control over the other. The following are the four ways by which AE's formed through participation in capital:

i. **One enterprise holding at least 26% voting power in the other enterprise, directly or indirectly.** [S.92A(2)(c)] For example, if A(India) holds 60% Equity shares in B(UK) who further holds 40% equity shares in C (US), then A and B are AEs since A directly owns 60%. Similarly, B and C are AEs since B directly owns 40%. A and C would also be AEs as A indirectly hold more than 26% voting rights in C. In another case, if A(India) holds 30% non-voting preference shares in B(US), then A and B will not be associated enterprises as preference shares does not carry any voting rights.

ii. **Same enterprise or person holds at least 26% of the voting rights in each enterprise, directly or indirectly, then the two enterprises are associated** [S.92A(2)(b)]. For example, Mr. A hold 60% of F1(UK) and Mr. holds 40% of F1. Mr. A also indirectly holds 49% of H(India) through F2 and Mr. directly holds 51% of H. This would make H and F2 AEs. In *Diageo India (P.) Ltd. v. Dy. CIT*¹⁰ it was held that S.92A(2)(b) would apply to cases where any person or enterprise holds 26% or more voting power in two or more companies. In *Kaybee*

⁶ Chaturvedi & Pithisaria: Income Tax, 6e 2014, Lexis Nexis (2014)

⁷ [2016] 71 taxmann.com 172/159 ITD 680/181 TTJ 798(Bang.)

⁸ [2012] 26 taxmann.com 61(Mum)

⁹ [2013] 38 taxmann.com 382(Hyderabad-Tribunal)

¹⁰ [2011] 13 taxmann.com 62(Mum)

(P) *Ltd. v. ITO*¹¹ it was held that where the director and 99.9% shareholder of assessee-company was also the director and CEO of a Singapore company, and he was also a part of the decision-making process of both companies, both companies were AEs of each other.

iii. **Lender advances loan which is 51% or more of the book value of the borrower enterprise.** [Section 92A(2)(c)]. For example, Enterprise A advances 70 crores to Enterprise B whose total book value of assets is 100 crores. Here, as 70 crores is greater than 51% of 100 crores. Therefore, A and B are associated enterprises.

iv. **When one enterprise guarantee 10% or more of the total borrowings of the other, then the two enterprises are associated.** [Section 92(A)(2)(d)]

II. Participation in Management

Participation in management of an enterprise may happen through the appointment of key persons such as the directors and executive members. However, merely having the power to appoint them is not sufficient to establish AE relationship. There must be actual exercise of such powers.¹² According to section 92(A)(2)(e) and (f), AE is established where one enterprise or same persons appoints more than 50% of the Board of Directors or members of the Boars/Governing body, or even one or more of the executive directors /executive members of the board/governing body of the other of the other or two or more enterprises. For example, Y appoints 9 out of the 15 directors in X Ltd, making X and Y AEs. Similarly, if Y also appoints 4 out of 7 directors in Z ltd, then Y and Z are AEs. X and Y would also become AEs.

III. Participation in Control

In *Orchid Pharma Limited vs. DCIT*¹³, the ITAT Chennai stated that a narrow approach to the definition of AE takes into account only “de jure” association, i.e., through formal participation in the capital or management. A wider approach would take into account not only de jure relationships but also de facto control through other modes of control such as commercial

¹¹ [2015] 57 taxmann.com 449/70 SOT 259/171 TTJ 536 (Mumbai-Tri)

¹² Vinod K Singhania, Dr. Kapil Singhania, Taxman’s Direct Taxes Law and Practice, pp.1323-1326, Taxmann Publications (2017)

¹³ Vinod K Singhania, Dr. Kapil Singhania, Taxman’s Direct Taxes Law and Practice, pp.1323-1326, Taxmann Publications (2017)

relationships in which one has dominant influence over the other.¹⁴ Thus, AE is established in the following cases as well:

- ☐ The manufacturing or processing of goods or articles or business of One enterprise is 100% dependent on the exclusive rights¹⁵ of the other [section 92A(2)(g)]
- ☐ At least 90% of the raw materials and consumables required for manufacturing and processing of goods/articles of one enterprise are supplied by the other enterprise or by persons specified by the other enterprise. The other enterprise has a dominant influence on the prices and other conditions related to supply. [S.92A(2)(h)]
- ☐ The goods or articles manufactured are sold to the other enterprise or persons specified by the other enterprise and the prices are influenced by such other enterprise. [S.92A(2)(i)]
- ☐ if both enterprises are controlled by an individual, or by an individual or his relative, or jointly by the individual and his relative, both enterprises are deemed to be associated enterprises. [section 92A(2)(j)]
- ☐ where one enterprise is controlled by a HUF, and the other enterprise is controlled by a member of such HUF or by a relative of a member of such HUF or jointly by such member and his relative. [section 92A(2)(k)]
- ☐ Where one enterprise is a firm, association of persons or Body of Individuals, the other enterprise must hold at least 10% interest. [section 92A(2)(l)]
- ☐ An existence of any relationship of mutual interest between two enterprises as may be determined by the CBDT. [section 92A(2)(m)]

Conclusion

Wrapping up, it is critical to clearly identify the existence of “associated enterprises” for taxation purposes as it forms the crux of transfer pricing. While Section 92A clause (1) provides a basic criterion to establish AE, it is required that at least one of the conditions listed under clause (2) must also be fulfilled at any time during the previous year. Wherever the nature of

¹⁴ICSI, Transfer Pricing, (2018), <https://www.icsi.edu/media/webmodules/publications/Transfer%20Pricing.pdf>(Last Accessed on 25th March, 2022)

¹⁵ It includes the use of knowledge, patents, copyrights, trademark, licenses, franchises or similar business or commercial rights.

relationship, i.e., direct or indirect has not been mentioned, it is comprehended as a direct relationship between the enterprises. Thus, there is a complex interplay of the two clauses of section 92A.