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August
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Article

Deemed Associated Enterprises - Interplay between Sections 92A(1) and 92A(2)

By **Sanmati Raonka**

Section 92 of the Income-tax Act, 1961 ('**the Act**') provides that any income arising from an international transaction shall be computed, having regard to the arm's length price. The expression "international transaction" is defined in Section 92B of the Act to mean a transaction between two or more "Associated Enterprises" ('**AE**'), where either or both of whom are non-residents.

The expression AE is defined under section 92A of the Act in two parts. Section 92A(1) of the Act defines AE to mean an enterprise (a) which participates in the management or control or capital of the other enterprise, or (b) in which persons participating in management or control or capital are the same persons who participate in the management or control or capital of another enterprise. Section 92A(2) of the Act contains a deeming provision, giving specific illustrations [clauses (a) to (m)], to indicate when two enterprises will be deemed to be AE.

The scope of this article is limited to examine if, any of the clauses (a) to (m) of sub-section (2) is satisfied, the transacting enterprises *ipso facto* become AEs without satisfying the requirement of sub-section (1); or whether fulfilment of conditions of either sub-section (1) or sub-section (2) is suffice for creating a relationship of AE in the context of transfer pricing provisions contained in the Act. In another words, this article deals with the question as to whether sub-sections (1) and (2) of Section 92A of the Act are to be read together conjunctively or these sections operate independent of each other.

Legislative history of Section 92A

Section 92A of the Act was inserted by the Finance Act, 2001 with sub-section (2) having the opening words "*Two enterprises shall be deemed to be AEs if, at any time during the previous year* …". It was soon after amended by Finance Act, 2002 wherein the said phrase was substituted with the phrase "*For the purposes of sub-section (1), two enterprises shall be deemed to be AEs if, at any time during the previous year*…". Noticeably, when the sub-section (2) was initially introduced, it served as an independent condition for treating two enterprises as AEs. However, post the amendment in 2002, a link was established between the two sub-sections (1) and (2).

The memorandum to Finance Bill, 2002 clarified the purpose of amendment. As per the memorandum, for considering an enterprise as an AE of the other enterprise, not only conditions of section 92A(1) but also any of the clauses of section 92A(2) must be satisfied. This can be understood by way of following diagram:

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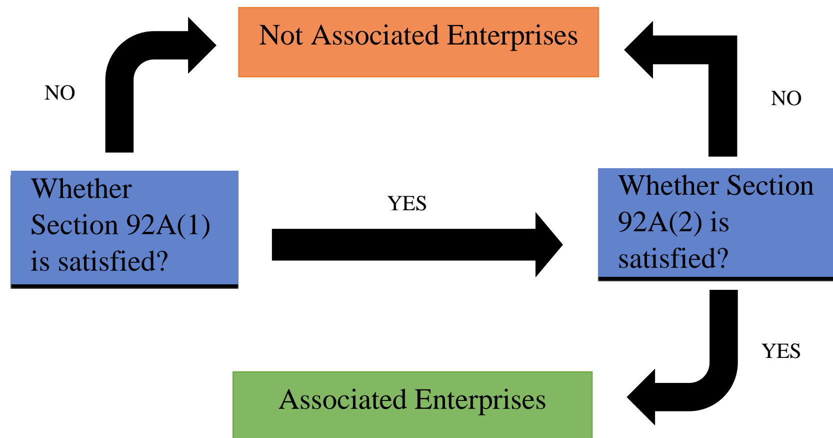

Judicial Precedents

The Ahmedabad Bench of the Income-tax Appellate Tribunal in *Veer Gems*[1] interpreted 92A(2) to be exhaustive illustrations of participation in management, capital or control as envisaged in Section 92A(1) of the Act. The Tribunal held that, where one enterprise satisfies the condition of Section 92A(1) due to there being de facto or de jure participation in management, capital or control by one of the enterprise in the other enterprise, the two enterprises do not become AEs, unless the conditions specified in Section 92A(2) of the Act are satisfied. The Tribunal further held that **Section 92A(1) and (2), in that sense, are required to be read together, even though Section 92A(2) does provide several deeming fictions which *prima facie* stretch the basic rule in Section 92A(1)** quite considerably on the basis of, what appears to be, manner of participation in "control" of the other enterprise. This order of the tribunal was upheld by the Gujrat High Court[2].

The Bangalore Bench of Tribunal in *Page Industries*[3] held that to constitute a relationship of AE, parameters laid down in both sub-sections (1) and (2) must be cumulatively satisfied. The Tribunal also held that, even if any of the clauses of sub-section (2) is applicable, if conditions of sub-section (1) are not satisfied, the enterprises would not be regarded as AE. The principle laid down in this order was followed by Chennai bench of the Tribunal in *Orchid Pharma*[4].

At this juncture, it is also apropos to refer to another decision of the Tribunal in *Kaybee*[5] wherein it was held that section 92A(2), being a deeming fiction, enlarges the scope and meaning of expression 'AE' provided under section 92A(1), but still, the conditions stipulated in the clauses of section 92A(1) must be fulfilled for enterprises to be regarded as AE. A conjoint reading of these decisions suggest that two enterprises can be regarded as AE only if the conditions stipulated in Section 92A(1) as well as in Section 92A(2) are cumulatively satisfied.

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[1] *Assistant Commissioner of Income-tax* v. *Veer Gems*, [2017] 183 TTJ 588 (Ahmedabad-Trib)
[2] [2017] 298 CTR 98 (Gujarat).
[3] *Page Industries Limited* v. *Deputy Commissioner of Income-tax*, [2016] 159 ITD 680 (Bangalore)
[4] *Orchid Pharma Limited* v. *Deputy Commissioner of Income-tax*, [2016] 162 ITD 303 (Chennai).
[5] *Kaybee (P.) Ltd.* v. *Income-tax Officer, Mumbai*, [2015] 43 ITR (Trib) 234 (Mumbai)

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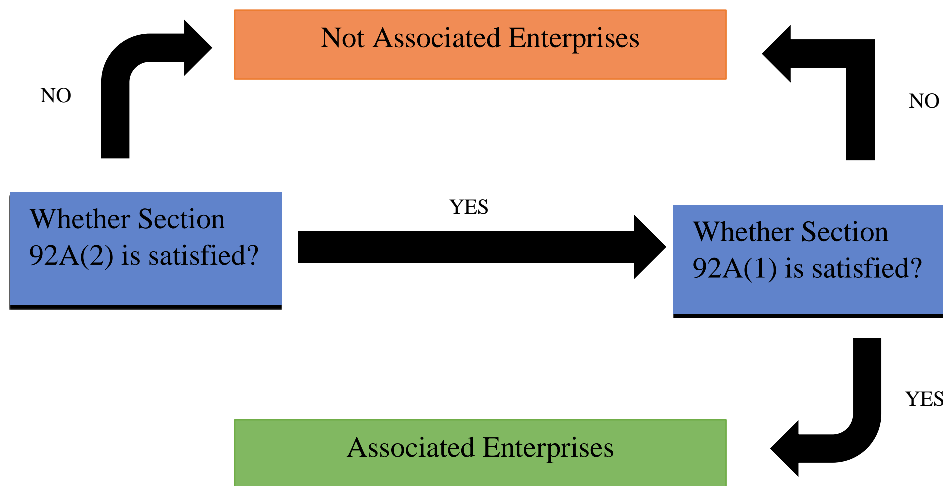
Author's viewpoint

As it is clear from the clauses enumerated in section 92A(2) of the Act, none of them independently prescribe any benchmark to imply that when one enterprise participates in the management or control or capital of two or more enterprises. The conditions prescribed therein are only indicative of the existence of such participation. Therefore, satisfaction of any of the conditions mentioned in 92A(2) will not by itself result in the enterprises being regarded as AE.

Accordingly, it can be inferred that section 92A(2) must be read with of section 92A(1) as the fiction provided under section 92A(2) comes into play only when conditions stipulated under section 92A(1) are satisfied. Thus, there is a strong reasoning to say that if any clause of section 92A(2) is independently satisfied, it will not automatically result in establishing relationship of AE. This can be understood by way of following diagram:



Analysis of the treaty law

India's tax treaties are based on both UN Model and OECD Model, with importance to source- based taxation. Article 9 of OECD and UN Model conventions, which deal with AE, is virtually identical in both model conventions. The scope of Article 9 under both the model conventions extends only to enterprise which participates directly or indirectly in the management, control or capital of an enterprise of the other contracting state. It is germane to note that treaties do not provide for illustrations or circumstances, deeming certain relationship to constitute AE. Accordingly, even if relationship of AE exists on the basis of application of any of the clauses of Section 92A(2) of the Act, it can be argued that by virtue of application of the treaty, unless there is actual participation in control, capital or management by enterprise into another, the transacting enterprises cannot be regarded as AE, applying the treaty law.

Conclusion

Sections 92A(1) and 92A(2) are to be read together and conjunctively. Besides the specific conditions laid down in sub-section (2), the condition of participation in the control, capital, and management of an enterprise by another

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enterprise should be independently satisfied in order to treat the two enterprises as AE of each other. Additionally, even the treaty law mandates the condition of actual participation in control, capital, and management for invoking the transfer pricing provisions.

[The author is an Associate, in Direct Tax Team of Lakshmikumaran & Sridharan at Mumbai]

Ratio Decidendi

Transfer pricing - Functional comparability for computing Arms' Length Price under TNMM

Delhi High Court has upheld the ITAT decision which in turn had upheld the exclusion of comparables observing that the nature of services provided by assessee under R&I segment were in nature of Knowledge Processing Outsourcing (KPO) and not of Business Processing Outsourcing (BPO), which is functionally dissimilar from some of assessee's comparable companies in terms of services as well as their risk profiles. The High Court noted that the nature of services provided by the assessee's comparable companies do not demonstrate even a degree of similarity with services rendered by the assessee that would be sufficient to qualify under Rule 10B(2) of Income Tax Rules. Referring to the Courts' decision in *Rampgreen Solutions v. CIT*, it noted that in Transactional Net Margin Method (TNMM), comparables which are offering services not entirely similar to controlled transaction, may be included only if difference has no material bearing on profitability and also when functional and risk profile differences are absent.

The business operation of assessee included Research and Information (R&I) Services division and IT Support Services division. In respect of R&I services, the assessee had selected 18 comparables companies whose average of adjusted operating margins was 14.50%. The TPO rejected certain foreign companies as comparables as they were engaged in providing BPO services and finally selected 8 comparables computing average PLI of 36.48%. [*Mckinsey Knowledge Centre* v. *PCIT* - Judgement dated 9-8-2018 in ITA 461, 526, 590, 82/2017, Delhi High Court]

Resident company when not an agent to holding non-resident company under Income Tax Section 163

Madras High Court has held that an Indian company (appellant) having no role in transfer of its share by its holding company, outside India, to a foreign company also outside India, cannot be treated as an agent to its holding company for the purposes of Section 163(1)(c) of Income Tax Act. There was a Share Transfer Agreement between Clayton Dewandre, UK (Holding company) and WABCO, Singapore, in terms whereof former transferred its share-holding in WABCO, India to WABCO, Singapore. The Show Cause Notice alleged that the capital gains has arisen directly as a result of consideration received by the holding company from the appellant and the appellant was proposed to be held as an agent under Section 163(1)(c) of Income Tax Act, in event of any demand against Clayton Dewandre, UK in assessment proceedings for AY 2014-15. The Court however reiterated the Delhi High Court DB decision in

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General Electric Co. v. Dy. Director Income Tax wherein it was held that merely because those shares were related to Indian company, that would not make the Indian company an agent for deemed capital gain earned by foreign company. The High Court while allowing the writ petition set aside the impugned SCN. [*WABCO India* v. *DCIT* – Judgement dated 1-8-2018 in W.A. No. 884 and C.M.P Nos. 8825 and 7726 of 2018, Madras High Court]

Deductions of employee's contribution towards EPF when cannot be claimed

Kerala High Court has held that employer cannot claim deduction in subsequent year if it fails to pay employees contribution under EPF Act, 1948 before due date but pays it belatedly. The Company had failed to pay the employees' contribution under Employees' Provident Funds and Miscellaneous Provisions Act, 1952 and the Employees' State Insurance Act, 1948 before the due date. The High Court in this regard noted that such contribution will not be affected by Section 43B of Income Tax (employers' contribution) as they are regulated by Section 2(24) (x) and Section 36(1)(va) of Income Tax Act. Division Bench earlier decision in the case of *Merchem Ltd.* was agreed with.

Reliance was placed upon the Supreme Courts' decision in *Alom Extrusions* which had observed that the employees' contribution which is deducted at the time of payment of salary is received by the employer-company and is treated as income under Section 2(24). Further, the Apex Court had noted that if employees' contribution is not remitted into the funds within due date, the employer not only has defaulted the stipulation in labour legislation but has received income which is an illegal enrichment. [*Popular Vehicles & Services* v. *CIT* – Judgement dated 2-7-2018 in I.T.A. No. 172 of 2016, Kerala High Court]

Interest income received on mobilisation advance to contractors is 'capital receipt'

The assessee has received interest income on mobilisation advance given to the contractors to ensure smooth commencement and completion of the work. The said interest income was later adjusted in the final bills of the contractor and resulted in reduction of the cost of construction. The revenue found the said income to be assessable as a revenue receipt in relevant subject year. The High Court has held that interest income received on mobilisation advance is in nature of Capital receipts as the activities were directly connected with or incidental to work of construction of plant undertaken by assessee and failure to provide these would have resulted in escalation of charges of construction. The Supreme Courts' three-judge decision in *CIT v. Bokaro Steel Ltd.* was referred to reject plea that such income is revenue income. [*Roads and Bridges Development Corporation* v. *ACIT* – Judgement dated 6-7-2018 in I.T.A No. 376 of 2010, Kerala High Court]

Section 10A exemption – FT (D&R) Act does not have overriding effect on Income Tax Act

The assessee is a 100% Export Oriented unit and a software exporter, who claimed benefit under the Software Technology Parks Scheme formulated under Section 3 of Foreign Trade (Development and Regulation) Act, 1992 (FTDR Act). The notification at Annexure-A under Section 3 of FTDR Act granted complete exemption from the income tax payable for 5 years. The Assessing Officer granted benefits under Section 10A of Income Tax Act, 1961 but refused to grant exemption under FTDR Act. The assessee took up the matter in appeal asserting that they are entitled to blanket exemption of 5 years as available under Annexure–A notification brought out by virtue of Section 3 of FTDR Act.

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The Tribunal held that assessee can claim exemption only under the Income Tax Act. The High Court, having agreement with the findings of Tribunal, held that FTDR Act does not have non-obstante clause conferring overriding effect over Income Tax Act, hence, rejected assessees' contention of blanket exemption for 5 years. It was also observed that travel charges, telephone charges and professional consultancy charges reimbursed by foreign clients for services rendered outside country are to be excluded from the total turnover under Section 10A when the same has to be excluded from export turnover. The Apex Courts' recent decision in *CIT v. HCL Technologies* was relied upon to conclude the abovementioned findings. [*IBS Software Services v. Dy. CIT* –Judgement dated 20-7-2018 in I.T.A. Nos. 411, 412, 415, 416 & 418 of 2010, Kerala High Court]

Expenditure in education of director's son not a deductible expenditure when not incurred exclusively for purposes of business

The assessee incurred expenditure under the head 'Management Training and Development expenditure'. This expenditure was incurred for higher education and training of a son of one of the directors who had been sent to USA for course in Business Administration. The High Court has held that expenditure in higher education and training of son of director is not a deductible allowance as it is not incurred wholly or exclusively for purpose of business of the assessee. It noted that assessee was engaged in manufacturing copper foils and course (Business Administration) for which son was sent abroad had no direct nexus with business activities. The High Court distinguished the Supreme Courts' decision in *Sakal Papers v. CIT* which was relied upon by the assessee, as the daughter of the director in that case was post-graduate in Arts with English and French subjects and was serving with the company for 5 years before she was sent for the training and further education in journalism. Also, she again started working with editorial department of Sakal Papers after securing the degree. [*Indian Galvanics* v. *CIT* – Judgement dated 6-7-2018 in I.T.A. No. 199 of 2002, Bombay High Court]

Area based benefit u/s 80-1C – Substantial expansion after 5 years, effect

The assessee availed area-based deduction under Section 80-IC of Income Tax Act, 1961 on the ground that they had set up their units in the State of Himachal Pradesh and after availing the deduction at the rate of 100% they wanted continuation of this rate of 100% for the next 5 years on the ground that they had made substantial expansion. The Supreme Court has held that when assessee has claimed an area based deduction under Section 80-IC of Income Tax for 5 years at the rate of 100% then they would be entitled to deduction for remaining 5 Assessment Years (AY) at the rate of 25% (30% where assessee is a company) and cannot claim deduction at the rate of 100% for remaining 5 years for carrying out substantial expansion in its unit. The Supreme Court observed that once initial AY commences and an assessee, by virtue of fulfilling the conditions of Section 80-IC(2) starts enjoying deduction, there cannot be another 'initial Assessment Year' for the purposes of Section 80-IC within the given period of 10 years. [*CIT v. Classic Binding Industries* – Judgement dated 20-8-2018 in Civil Appeal No. 7208 of 2018, Supreme Court]

Simultaneous deduction under section 80IA and 80HHC permissible

The tax payer had set up a new industrial unit which were eligible for deduction under section 80IA of the IT Act. A part of the goods produced

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from the new unit was exported, the profits from which were eligible for deduction under section 80HHC of the IT Act. The tax payer claimed deduction under both the sections. The AO denied deduction under section 80IA on the ground that allowing simultaneous deduction under more than one section was against the basic principle of taxation, as explained by the Supreme Court in Escorts Ltd v UOI [199 ITR 43]. The Tribunal upheld the order of the AO. Reversing the order of the Tribunal, the High Court held that, so long as the cumulative deduction does not exceed the gross total income of the tax payer, simultaneous deduction is permissible. The High Court also held that the judgment of the Supreme Court in Escorts Ltd, which was rendered in the context of allowability of expenditure, cannot be applied in interpreting provisions enabling deduction - more so when the sections do not exclude allowability of deduction under any other section. [*Indian Gum Industries* v. *JCIT* - ITA 802 of 2002, decision dated 13th July, 2018, High Court of Bombay]

Payment received towards reimbursement of salary for seconded employees is not Fees for Technical Services

The tax payer, a Singapore based company, had seconded one of its employees to its Associated Enterprise (AE) in India, for assistance in business development. The seconded employee was receiving a part of his remuneration from India and a part from Singapore. As the employee was wholly under the control of the AE, the AE reimbursed the salary paid in Singapore to the tax payer. The AO/TPO treated the secondment as rendition of technical services (FTS) provided by the tax payer. On an appeal, ITAT observed that as per the arrangement between the parties, the seconded employee was working solely for the Indian AE and hence, the reimbursement of salary cost cannot be characterised as FTS. Further, the Tribunal held that such reimbursement is not FTS even under the India-Singapore DTAA as the seconded employee had not made available any technology or know how to the Indian AE. [*Morgan Stanley Asia (Singapore) Pte. Ltd.* v. *DCIT* [2018] 95 taxmann.com 165 (Mumbai – Trib.)]

Cost incurred on capital work-in-progress can be treated as 'cost of acquisition', when plant and machinery is sold along with capital work-in-progress

The tax payer sold its paper manufacturing plant, including certain capital work-in-progress (WIP). In computing the taxable gain from the transfer, the tax payer treated the cost of capital WIP as part of cost of acquisition of the asset. The AO (on the directions of the Pr. CIT), however, disallowed such loss on the ground that in terms of section 50(2) of the IT Act, the cost of capital WIP could not be taken into account in determining short term capital gain/loss chargeable under section 50 of the IT Act. The ITAT, on the other hand, stated that the view of the AO that the expression 'block of assets' does not include in its ambit 'capital WIP' because no depreciation thereon is allowed is incorrect. As per the Tribunal, section 50(2) only lays down the manner of computation of capital gain on sale of depreciable assets but does not define the term 'Capital Asset'. Section 2(14) of the IT Act defines the term 'Capital Asset' in an inclusive manner and therefore, the Tribunal held, capital WIP would also form part of the block of asset that was transferred. When capital WIP is to be treated as a part of the block of asset, the cost incurred for putting up the asset was required to be treated as 'cost of acquisition' in arriving at the taxable capital gain/loss. [*Titagarh Industries Ltd.* v. *DCIT* - [2018] 95 taxmann.com 288 (Kolkata – Trib.)]

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Share of loss from a firm will not be allowed as a deduction in computing book profit under section 115JB

The tax payer, a private limited company, was a partner in two firms. Its share of losses in the firm was debited to the profit and loss account of the tax payer. In computing its profit for the purpose of section 115JB, the tax payer did not add back share of loss from the two firms. The AO added back the loss in computing the book profits under section 115JB on the ground that since share of income from a firm is exempt from tax under the IT Act, the loss therefrom cannot be allowed as a deduction. On an appeal, the Tribunal observed that, share of loss is nothing but share of negative income; Explanation 1(ii) to Section 115JB of the Act mandates reduction of income to which section 10 applies if such income is credited in the profit and loss account. Applying the explanation, the Tribunal held that the share of loss from the firm is to be excluded in computing book profits under section 115JB of the IT Act. [*DCIT* v. *Fixit (P.) Ltd.* - [2018] 95 taxmann.com 188 (Chennai - Trib.)]

News Nuggets

Draft notification for electronic process for obtaining certificate for lower or NIL tax withholding or lower collection of tax

On August 17th, the CBDT issued the draft notification to make the process of issuing lower or NIL withholding certificate, electronic. As per Section 197 of the Income Tax Act, the Assessing Officer is empowered to issue the certificate for NIL or lower rate of deduction of tax at source or lower rate of collection at source (section 206C). The payer or payee of the income may apply for the same. Further, various rules and Form No. 13 have been prescribed in this regard. The rules, *inter alia* require the Assessing Officer to consider tax payable on estimated income, existing liability and state that the certificate shall remain valid for such period of the previous year as specified in the certificate unless it is cancelled by the Assessing Officer before the expiry of the period. The draft notification provides for electronic filing of the application and issuance of the certificate. Suggestions have been invited from stakeholders and the same may be sent electronically by September 4, 2018.

Return for AY 2018-19 can be filed without linking Aadhar with PAN

The Delhi High Court has directed the Income Tax department to allow assessee to file their returns for Assessment Year 2018-19 without any insistence of linkage of Aadhar and PAN numbers and also without instance of production of Aadhar enrolment proof. The High Court relied upon CBDT Circular dated 30-6-2018 which has suspended the requirement of Aadhar linkage with PAN till 31-3-2019. The High Court in the case of *Shreyasen v. UOI* further directed CBDT to create a platform in digital form to enable 'opt out' from mandatory requirement of furnishing Aadhar registration or Aadhar linkage till exemption subsists.

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