

UNDERSTANDING OF RELATIONSHIPS, TRANSACTIONS AND SECONDARY ADJUSTMENTS



CA Virav Dedhia
Email : ca.viravdedhia@gmail.com

Introduction:

The way that a person behaves or feels about the other person is called as a relationship. It can be about a group of people or countries or companies or any other business units. This is the definition of relationship as per Google. However, like we all know that Google and tax laws do not get along. Thus, in this article, I would throw some light with respect to the definitions of related party and what would be termed as a related party transaction from a transfer pricing perspective.

Definition as per Section 2(41):

As per the Income-tax Act, 1961 ('the Act') the relative is defined under various sections. These definitions are applicable specifically to the provisions of the Chapters that they are provided upon with an exception to the definition in Section 2. Accordingly, each definition is unique and plays a critical role for the provision applicable to it. To start with, Section 2(41) of the Act provides a generic definition of the term relative which is applicable in all the cases wherein there is no specific definition given for related party. This definition covers "relative", in relation to an individual wherein the relative means spouse, siblings and any lineal ascendant or descendant of that individual.

Section 40A(2)(b):

Further, Section 40A(2)(b) provides a wider definition of the term relative wherein it states that a relative for an individual is any relative of the said individual. The term relative here means the same as defined under Section 2(41). However, if the assessee taxpayer is a company, firm, association of persons or Hindu Undivided Family ("HUF") then the relative would include any director of the company, partner of the firm, member of the association or a member of the HUF family, or any relative of such director, partner or member as the case may be. One prominent aspect of this Section is, one person should hold atleast 20% of voting rights in the other entity directly for that person to be called as a relative of that entity. This holds significance particularly in case of an incorporated company, a partnership firm (including limited liability partnership) and an association of persons. The definition under this Section 40A(2)(b) is applicable primarily for computing and reporting the extent of expenditure allowed with respect to related parties while determining the profits and gains from business or profession.

Considering the above definition, one may wonder that the domestic and international expenditure transactions with almost all of the individual's relatives and the related parties of other assesses like companies, association of people get covered within Section 40A(2)(b). Thus, one may wonder what would be the coverage of the Chapter X.

Section 92A - Determining related parties:

In this regard, the Chapter X of the Act provides for special treatment towards international related party transactions and certain specified domestic transactions. If we look back in history then Chapter X was introduced with a mindset to keep a check on the shifting of tax base from India to a related party in another jurisdiction. The said chapter provides definition of related parties covering not only direct relationship but also indirect relationships with a resident and a non-resident. Section 92A provides definitions about the nature of relationships that would tantamount to be international related parties and consequently the transactions with them to be international related party transactions.

Let us look into each of the clauses of Section 92A with examples to understand the nature of relationships that would be covered.

Sec No.	Clause as per Act	Instances
1(a)	Which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise	A Pvt Ltd participates in the management of A LLP which has a capital stake in A Inc. Accordingly, A Pvt Ltd, A LLP and A Inc. are related parties as per this clause.
1(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	Person A has management control in Company ABC Pvt Ltd and person A also has an equity capital control in PQR Inc. Accordingly, Company ABC Pvt Ltd and PQR Inc. are related party as per this clause.
2(a)	One enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise.	A Pvt Ltd holds more than 26% voting power in A Inc. Accordingly, A Pvt Ltd and A Inc. are related parties as per this clause.
2(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.	Person A has more than 26% voting power in Company ABC Pvt Ltd and Person A also has more than 26% voting power in PQR Inc. Accordingly, Company ABC Pvt Ltd and PQR Inc. are related party as per this clause.
2(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	A Pvt Ltd has advanced loan amounting to \$50 million to A Inc. The total assets owned by A Inc. is \$100 million. Accordingly, A Pvt Ltd has advanced loan more than 50% of A Inc.'s assets. Thus, A Pvt Ltd and A Inc. are related parties as per this clause.
2(d)	One enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise	A Inc. has provided corporate guarantee for \$10 million on behalf of A Pvt Ltd's total debts of \$50 million. Accordingly, A Pvt Ltd is a related party of A Inc. as per this clause.
2(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	A, B and C are the executive directors of ABC Inc. These directors also participate in the management of ABC Inc. Directors A and B are appointed by PQR Pvt Ltd. Thus, PQR Pvt Ltd and ABC Inc. are related parties of each other as per this clause.

Sec No.	Clause as per Act	Instances
2(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	ABC Pvt Ltd has appointed executive directors 3 out of 4 directors on the governing board of PQR Ltd. ABC Pvt Ltd has also appointed 2 executive directors out of 3 directors of MNO Ltd. Thus, ABC Pvt Ltd, PQR Ltd and MNO Ltd are related parties of each other as per this clause.
2(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, trademarks, 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.	A Inc. has appointed ABC Pvt Ltd as a contract manufacturer to produce the products of "A". A Inc. would share its know-how and technology exclusively to ABC Pvt Ltd for manufacturing the products of A. ABC Pvt Ltd is not allowed to engage with any other third party to produce products for that company. Thus, ABC Pvt Ltd and A Inc. are determined to be international related parties as per this clause.
2(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	ABC Pvt Ltd is engaged in manufacturing of plastic chairs. ABC Pvt Ltd procures the plastic granules being a critical raw material forming 95% of the materials used to manufacture plastic chairs from A Inc. Further, A Inc. also guides ABC Pvt Ltd on the pricing of the product and the markets to be targeted. Accordingly, A Inc. is an associated enterprise of ABC Pvt Ltd as per this clause.
2(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	A Inc. instructs ABC Pvt Ltd to manufacture plastic products and sell those plastic products to B Inc. at a rate of \$5 per plastic chair. A Inc. has also decided on the terms and conditions of this sale as per this clause.
2(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	Person M has control over the management of entity A Inc. and Person N (being father of M) has control over the management of entity ABC Pvt Ltd. Accordingly, entity A Inc. and ABC Pvt Ltd are associated enterprises of each other as per this clause.

Sec No.	Clause as per Act	Instances
2(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	Person M HUF has control over the management of entity A Inc. and Person N (being member of M HUF) has control over the management of entity ABC Pvt Ltd. Accordingly, entity A Inc. and ABC Pvt Ltd are associated enterprises of each other as per this clause.
2(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	A is an AOP of various persons resident outside India, M/s B LLP holds 15% stake in the A - AOP. Thus, pursuant to this clause, A and M/s B LLP as per this clause.
2(m)	there exists between the two enterprises, any relationship of mutual interest, as may be prescribed	Currently, nothing is specified under this clause.

Apart from the above, the Permanent Establishments, Branch offices, Project offices of the foreign entities are separately defined as "Persons" as per Section 2 of the Act. Thus, the relationship between these entities with their Head-Offices or holding entities would also be recognised as a related party i.e. an associated enterprise.

It can be seen from the above clauses and their relative examples that Section 92A covers a wide range of entities to be determined as an associated enterprise or related entity of one-another. To understand this better, let us look at a typical case to see how the provisions of related party function as per the Act. For instance, A Inc. and Microsoft Inc. enter into a mutual agreement to provide Microsoft's Office 365 suite to all the computers or laptops of A Inc. along with any entity which is part of A Inc. at a discounted price which is not normally offered to any retail customer. A Pvt Ltd being part of the A Inc. Group engages in a transaction with Microsoft Inc. to procure Office 365 suite pursuant to the primary agreement or negotiations of A Inc. then the transaction between A Pvt Ltd and Microsoft Inc. would be deemed to be an international transaction as per the Act. In this case though the transaction was between A Pvt Ltd and Microsoft Inc. but the primary arrangement was between A Inc. and Microsoft Inc. which governed the transaction of A Pvt Ltd and Microsoft Inc. thus the provisions of related party triggered as per the Section 92A of the Act.

Section 92B - Determining the related party transactions:

Having looked at the nature of relationships and the determinants of associated enterprise, we shall now try to understand the nature of transactions that would be covered by the definition of international transactions. The international transaction has been defined in Section 92B of the Act.

Section 92B is an inclusive definition which provides to include transactions in the nature of purchase or sale of tangible goods or capital assets, purchase or sale of intangible goods or capital assets (*for instance tradename, right to use, licenses, commercial secret, marketing channel, distribution network, carbon credits, etc.*), rendering or availing of services, provision of corporate guarantee, providing or availing free of cost goods

or services, cost pooling arrangements, mutuality agreements or arrangements, or any other cost or expense incurred or to be incurred in connection with any benefit or service or facility provided or to be provided. Thus, all those transactions which have a bearing on the profits or losses or incomes or assets of the entity would be covered as an international transaction.

It is pertinent to note here that these transactions whether incurred or to be incurred between two or more related parties where either or both of them are non-residents then too it would be covered within the definition of international transaction as per the Act.

Additionally, the Act also clarifies that the transaction pertaining to restructuring or reorganisation would be an international transaction as per the Act irrespective of the fact if it has a bearing on the profits or incomes or losses or assets of the entity.

Let's understand the concept of two non-resident related parties entering into a transaction wherein it has a bearing on the Indian entity by this example, say A Inc. has entered into an agreement with B Pty Ltd to sale one of its many business divisions. Pursuant to this agreement, the ownership of shares of A Pvt Ltd being Group's captive entity solely functioning in that business division get transferred from A Inc. to B Pty Ltd than the transaction is determined to be a related party transaction which has an indirect bearing on A Pvt Ltd. Thus, this transaction is an international transaction which needs to be reported by the Indian entity as per the Act though it has been entered into between two non-residents as these type of transactions between two non-residents are indirectly be said to affect an Indian entity.

Section 92BA – Specified domestic transactions:

It can be perceived from the above that the relationship as per Section 92A and the list of transactions as per Section 92B are pretty wide in their coverage to keep a check on the tax base from being eroded. Moreover, the transactions are not only covered from an international perspective but certain domestic transactions have been defined in Section 92BA which also need to be analysed from the provisions of Chapter X.

The specified domestic transactions as per Section 92BA include transactions with entities enjoying tax-holidays or preferential tax rate. These include entities or divisions enjoying benefits under Special Economic Zones (SEZ) as provided under Section 10A, Software Technology Parks as per Section 10AA, entities in certain under-developed areas or entities engaged in certain specified businesses as per Section 80IA, 80IB, etc. of Chapter VI of the Act.

The specified domestic transactions were introduced recently in this Chapter X with a purpose to check whether the domestic entities are not engaging in erosion of tax base from a high tax entity to a low or no tax entity.

The specified domestic transactions require a check not only between the related parties or associated enterprises, it requires a check on inter-departmental transactions of the same entity as well. For instance, A Pvt Ltd has its corporate office in Mumbai, sales office in Delhi, and branch office in Bengaluru, and manufacturing unit in a SEZ location. The corporate office and branch office looks into the day-to-day functioning of the manufacturing unit like payroll processing, support in statutory filings, etc. For rendering these support services to the manufacturing unit, the corporate office and branch office recovers a consideration from the manufacturing unit in SEZ. Further, the manufacturing unit in SEZ transfers its goods to sales office in Delhi for sale to third parties. According to the Section 92BA, these inter-departmental transactions between SEZ unit and other office locations i.e. Mumbai, Delhi and Bengaluru would be subjected to the provisions of Chapter X.

Section 92CE: Secondary adjustment a path breaking change:

The Organisation for Economic Cooperation and Development (OECD) and G20 nations have been discussing on the ways to prevent the erosion of the tax base. In this regard, a unique concept of secondary adjustment has been introduced. This section will discuss the concept of secondary adjustment in detail.

"Primary Adjustment" to a transfer price, means an increase in the total income or reduction in the loss while determining the transfer price in accordance with the arm's length principle. The various types of primary adjustment are classified as adjustments which are:

- a) Made suo-moto by the assessee in a return of income;
- b) Made by the assessing officer and the same has been accepted by the assessee;
- c) Is determined by an advance pricing agreement entered into by the assessee on or after 01 April 2017;
- d) Is made as per the Safe Harbour Rules as per Section 92CB; or
- e) Is arising out of the mutual agreement procedure of Section 90 or 90A.

Accordingly, if the assessee satisfies any of the above criteria then the statute requires the assessee to undertake a secondary adjustment. "Secondary Adjustment" means an adjustment in the books of account of the assessee and its associated enterprise to reflect the actual allocation of profits between the assessee and its associated enterprise are consistent with the transfer price determined as a result of primary adjustment, thereby removing the imbalance between cash account and actual profit of the assessee.

However, the assessee is exempt from undertaking the secondary adjustment if the value of primary adjustment is less than INR 1 crore or the adjustment has been in respect of an assessment year commencing prior to 01 April 2016.

The statute also provides that the amount of secondary adjustment not only needs an adjustment in the books of account but also the said money needs to actually flow into the assessee vide an appropriate amount of foreign currency. In case the assessee fails to do so then the amount of secondary adjustment would be deemed to be a loan to the associated enterprise and the same would attract an interest chargeable to tax in the hands of the assessee.

The statute also provides a way out to those assesses who do not wish to repatriate foreign currency into the books of assessee. The way out calls for payment of an additional tax at the rate of 18% on the said amount of adjustment. Thus, if the assessee who do not wish to avail foreign currency into its books than an option to pay an additional tax and settle the dues with the Revenue. It is pertinent to note here that the tax-rate of 18% is equivalent to the erstwhile dividend distribution tax rate.

Let us understand the above by way of an example, A Inc. has undertaken a transaction pertaining to availing of software development services from A Pvt Ltd.

Sr. No.	Particulars	Amount (In INR)
A	Assessee's arm's length sale consideration (Cost Plus 8%)	25,00,00,000
B	Assessing Officer determined arm's length sale consideration (Cost Plus 15%)	26,62,03,704
C	Adjustment value determined during assessment proceedings (A - B)	1,62,03,704
D	Additional foreign currency to be paid by A Inc to A Pvt Ltd	1,62,03,704
E	In case option D is not availed, the assessee A Pvt Ltd has an option to pay an additional tax @ 18% of "D"	29,16,670
F	In case, the assessee does not opt for "D" or "E" than the amount of adjustment as per "C" would be deemed to be an inter-company loan whose interest ¹ would be chargeable to tax in India.	

It is pertinent to note here that the assessee (in this case A Pvt Ltd) would neither be allowed any deduction nor be allowed any set-off of refund or brought forward losses or existing taxes paid, if any while opting for option E in the above table.

If we look at the concept of secondary adjustment from a global perspective then there are few countries who have adopted an approach similar to that of India, while there are certain other economies who have adopted only single option of either repatriation i.e. option "D" above or additional tax payment i.e. option "E".

Problems faced in other laws:

As we note from above that the secondary adjustment concept asks the assessee to record the adjustment value in the books of account. It maybe thus pertinent to understand that in case the assessee accepts the primary adjustment during the course of assessment proceedings which usually occur post two financial years than in which financial year would the assessee undertake this adjustment. On reading of the general accounting principles, one may consider the adjustment in the previous financial year if the event of such acceptance of the assessing order occurs before the signing of the statutory financial statements or in the on-going financial year if the event occurs after the signing of the statutory financial statements. The value of the said adjustment can be considered to give same effect as that provided to a prior period income or expense.

One another aspect that needs to be looked upon is the indirect-taxes i.e. Goods and Service Tax (GST) which has to be charged in certain transactions with foreign enterprises. The assessee would have to disclose the adjustment amount in their GST returns while filing the same with the Revenue authorities. The assessee would also have to pay tax on the same with interest if the adjustment is recorded in the previous year's books of account.

¹Rule 10CB has prescribed an interest rate of SBI base rate + 325 bps if the original transaction is in Indian Rupees or an interest rate of 6 month LIBOR as on 30 September + 300 bps if the original transaction is in foreign currency.

If we look from Foreign Exchange Management Act or the Reserve Bank of India's foreign trade policies then the amount of foreign exchange has to be brought into India within 6 months from the end of the month in which the adjustment entry is recorded. Thus, if the assessee records the adjustment in the previous financial year's books of account than the assessee would be left with almost no time to repatriate the money back into India. However, the situation would be different if the assessee chooses to pay additional tax instead of seeking the remittance of foreign currency.

Apart from the above, since we are looking at the international transactions, one needs to also consider a wholistic approach i.e. from the Group perspective instead of keeping our focus only on India as there might be a situation that we miss out on the bigger piece as there are different rules globally. There might be a situation wherein the assessee may seek to raise the foreign currency but the same may not be allowed as a deduction in the other economy. Thus, one needs to consider all aspects before deciding on one of the options.

Conclusion:

Tax is one of the key sources of income for any economy. If the tax base of any economy is shifted then that country may be affected with a lower inflow of money resulting in lower economic development. On perusal of the above paragraphs, it can be construed that the Indian Revenue authorities are trying to keep a check on any transaction which may have an impact on the profits or losses or assets of the entity / unit of an entity if they have been entered into between the related parties or associated enterprises. The purpose to keep a check on such related party transactions is in accordance with the globally accepted principles of Base Erosion Profit Shifting (BEPS) as has been determined by a common meeting between the Organisation for Economic Cooperation and Development (OECD) and G20 nations.

