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TAX FLASH NEWS

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‘De Facto’ or ‘De Jure’ participation in the management, capital or control by itself is not relevant in establishing associated enterprise relationship in terms of Section 92A of the Income-tax Act

Background

The High Court of Gujarat (High Court) has upheld the decision of the Income-tax Appellate Tribunal, Ahmedabad (the Tribunal) in the case of Veer Gems (the taxpayer). The Tribunal earlier ruled in favour of the taxpayer and had held 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 (AEs) under sub-section (1) to Section 92A of the Income-tax Act, 1961 (the Act) unless any of the criteria specified in sub-section (2) to Section 92A is fulfilled.

Facts of the case

- The taxpayer, a partnership firm, is engaged in the business of manufacture and sale, domestic as well as exports, of polished diamonds. The partners of the firm were three brothers (say Mr. A, Mr. B, and Mr. C) along with their respective wife and children.

- During the relevant assessment year, the taxpayer had entered into certain international transactions with a Belgian entity, Blue Gems BVBA. The said Belgian entity was owned and controlled by another brother (say, Mr. D), along with his family (brother of Mr. A, Mr. B, and Mr. C).

- The Assessing Officer (AO) contended that since the Belgian entity is controlled by another brother i.e. Mr. D (along with his family) (brother of Mr. A, Mr. B, and Mr. C), it falls under the definition of an AE in terms of clause (j) to sub-section (2) to Section 92A[2] of the Act and, accordingly, made a reference to the Transfer Pricing Officer (TPO). The TPO made an adjustment under Section 92CA(3) of the Act.

- Aggrieved by order of the TPO, the taxpayer appealed to Commissioner of Income-tax (Appeals) [CIT(A)]. However, CIT(A) without discussing the primary issue of the existence of an AE relationship in terms of Section 92A of the Act, proceeded to examine the correctness of the Arm’s Length Price (ALP) adjustment and deleted the impugned adjustment. Aggrieved by the order of CIT(A), both the revenue authority and taxpayer (through cross-appeals) appealed before the Tribunal.

- The Tribunal ruled in favour of the taxpayer holding that the taxpayer and the Belgian entity are not AEs. Aggrieved by this, the revenue authorities appealed before the High Court.

Tribunal’s ruling[3]

The moot question before the Tribunal was that whether the Belgian entity can be considered as an AE of the taxpayer under Section 92A of the Act. Key observations made by the Tribunal are provided as under:

- Sub-section (1) to Section 92A of the Act decides the principle on the basis of which one has to examine the existence of an AE relationship between the transacting entities. The principal

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[1] Pr. CIT v. Veer Gems [In the High Court of Gujarat at Ahmedabad Tax Appeal No. 338 of 2017]

[2] Section 92A(2)(j) of the Act - 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.

[3] Please refer our detailed Flash News on Tribunal’s Ruling dated 19 January 2017

condition required to be fulfilled is the expression 'participation in management or capital or control' which is not a defined expression in the Act. To ascertain its meaning, one has to take recourse to sub-section (2) to Section 92A of the Act which gives practical illustrations, which are exhaustive and not simply illustrative (as clarified in the Memorandum explaining the provisions of the Finance Bill 2002). In this sense, sub-section (2) of Section 92A governs the operation of sub-section (1) to Section 92A of the Act.

- Hence, sub-section (1) and sub-section (2) to Section 92A of the Act have to be read together, and unless the provisions of one of the clauses listed under sub-section (2) to Section 92A of the Act are satisfied, even if one enterprise ends up having a *de facto* or even *de jure* participation in the management, capital, or control of the other enterprises, the two enterprises cannot be said to be AEs. The Tribunal cited various other judicial precedents[4] wherein a similar view was taken.

- As per the tax department's argument, clause (j) of sub-section (2) to Section 92A is to be invoked. The said clause provides "*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*". In the present case, the taxpayer is a partnership concern, therefore, it cannot be said to be controlled by 'an individual'.

- The department also gave references to clauses (k) and (m) of sub-section (2) to Section 92A of the Act. The Tribunal observed that section clause (k) refers to an enterprise controlled by an HUF, but an HUF has nothing to do with either of the enterprises. Similarly, clause (m) is only an enabling provision for prescribing any other relationship of mutual interest that can lead to the enterprises being treated as AEs but then no such relationship has been prescribed yet.

- While a certain degree of control may actually be exercised by these enterprises over each other due to relationships of the persons owning these enterprises, that itself is not sufficient to hold the two enterprises as AEs.

On the basis of the above contentions, the Tribunal held that the taxpayer and Blue Gems BVBA are not AEs in terms of Section 92A of the Act and consequently deleted the impugned additions.

Questions of law framed before the High Court

- Whether the Tribunal has erred in holding that the taxpayer and Blue Gems BVBA are not AEs within the meaning of Section 92A of the Act.

- Whether the Tribunal has substantially erred in deleting the ALP Adjustment made of INR 5,22,64,779/- under Section 92CA(3).

High Court's decision

- The High Court agreed with the observation of Tribunal that none of the provisions of Clauses j, k and l of sub-section 2 of Section 92A(2) of the Act are applicable in the present case and therefore, the taxpayer and Blue Gems BVBA are not AEs. Observations of High Court on the clauses of Section 92A(2) are reproduced below:

  - Clause (i) would apply in a case where goods or articles are manufactured or transferred by one enterprise and in the present case, M/s Blue Gems BVBA does not either manufacture or process any articles. It merely purchases rough diamonds from the international markets and supplies it to the taxpayer.

  - Clause (j) would apply when an enterprise is controlled by an individual. In the present case, both the enterprises are partnership firms and hence it can said that they are not controlled by any individuals.

  - Clause (l) would apply in a case where the enterprise is a partnership firm. However, for the applicability of the said clause, there has to be an enterprise in the nature of a firm and another enterprise who holds not less than 10% interest in such firm, which is not applicable in the present case.

- In view thereof, the High Court has held that the Tribunal has committed no error in holding that the taxpayer and Blue Gems BVBA are not AEs and hence the question of applying transfer pricing formula would not arise.

Our comments

The verdict of the High Court appears to be in line with the intention of the legislature (as was clearly provided in the Memorandum explaining provisions of Finance Bill 2002). It clearly depicts and further strengthens the point that Section 92A(1) and (2) of the Act are always to be read together and Section 92A(2) governs the operation of Section 92A(1) by controlling the definition of participation in management or capital or control by one of the enterprise in the other enterprise.

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[4] Orchid Pharma Ltd v. DCIT [2016] 76 taxmann.com 63 (Chennai) and Page Industries Ltd v. DCIT [2016] 159 ITD 680 (Bang)

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