KPMG

TAX FLASH NEWS

19 January 2017

'*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 Ahmedabad Bench of Income-tax Appellate Tribunal (the Tribunal) in case of Veer Gems[1] (the taxpayer) has 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 (AY), the taxpayer had entered into certain international transactions with a Belgian entity, M/s 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 the 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.

Tax department's contention

- The tax department argued that the taxpayer has made substantial purchases from the Belgian entity. It further contended that the taxpayer and the Belgian entity are controlled by the members of the same family and their close relatives. Hence, the Belgian entity is closely related to the

[1] ACIT v. Veer Gems (ITA No. 1514/Ahd/2012 - AY 2008-09); Veer Gems v. ACIT (C.O. No. 184/Ahd/2012 - AY 2008-09)

[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.

taxpayer and falls within the ambit of clause (j) to sub-section (2) to Section 92A of the Act. Accordingly, the taxpayer should have reported the transaction under Section 92E of the Act and should have justified the ALP of the transaction.

Taxpayer's contention

- The taxpayer argued that the Belgian entity does not fall under the definition of an AE as provided under Section 92A(1) read with Section 92A(2) of the Act. In the relevant AY, unlike the immediately preceding AY, the taxpayer's purchase from the Belgian entity did not exceed 90 per cent of the total raw material as required to trigger clause (h) of sub-section (2) to Section 92A. It further contended, on without prejudice basis, that conditions set out under sub-section (1) and sub-section (2) to Section 92A have to be read together and neither of the sub-sections of Section 92A can be read in isolation. It submitted that since there is no AE relationship with the taxpayer and the Belgian entity, the report under Section 92E of the Act is also not required to be filed and consequently there is no need to justify ALP of the said transaction.

Tribunal's ruling

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. The Tribunal findings are 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 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) to 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[3] 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, taxpayer is a partnership concern, therefore, it cannot be said to be controlled by 'an individual'.

- The department also gave references of 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 enterprise. 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 the Belgian entity are not AEs in terms of Section 92A of the Act and consequently deleted the impugned additions.

---

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

Our comments

This ruling reiterates that the sub-sections (1) and (2) to Section 92A of the Act are not to be read in isolation but should be read together. It further highlights that the '*De Facto*' or '*De Jure*' participation in the management, capital or control by itself is not relevant in establishing an AE relationship.

www.kpmg.com/in

Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

© 2017 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.