

GUIDANCE NOTE ON RELATED PARTY TRANSACTIONS

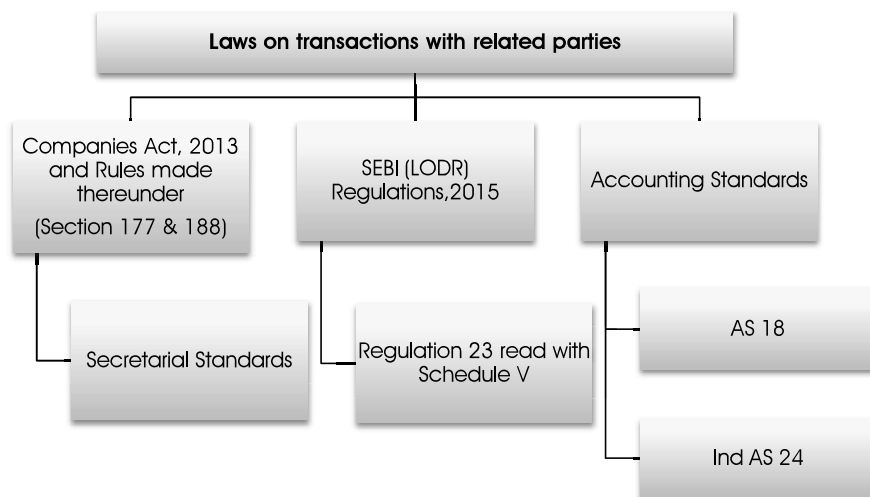
INTRODUCTION

A company, in the course of conduct of its business, enters into various transactions with different parties, including its related parties. Companies also carry on their activities through subsidiary companies and associate companies. Accordingly, related party relationships are a normal feature of business. Due to this relationship, related parties may enter into transactions that unrelated parties may not. For example, an entity that sells goods to its related party at cost might not sell on those terms to another customer. Also, transactions between related parties may not be made on the same terms as between unrelated parties. While entering into a contract or arrangement with a related party, such related party may get favoured treatment in terms of pricing or on some other conditions (such as credit period) which may affect the financial position or profit and loss of the company concerned. Hence, the law contains detailed compliance and disclosure provisions with respect to transactions with related parties.

Every transaction with a related party may not be a 'related party transaction' although every 'related party transaction' is necessarily a transaction with a related party.

Transactions with related parties need not always be disadvantageous to the parties concerned. The concern arises only when there is abuse of a related party transaction on account of conflict of interest and non-arm's length dealings which are beneficial to a related party but detrimental to the other stakeholders. The concern also arises when there is siphoning of funds and diversion of resources of the company. Transactions with related parties raise important concerns and hence transparency in such transactions is essential. Therefore, law requires certain specific compliances with respect to related party transactions.

In order to appreciate the nuances of related party transactions, it is necessary to understand the scope of the provisions of law, meaning of certain terms like goods, property, ordinary course of business, arm's length basis, etc. The law on transactions with related parties can be summarised in the following chart. However, there are several important aspects which need an explanation and hence this Guidance Note:



Transactions with related parties may be with respect to purchase or sale of goods or availing or rendering of services or may be with respect to financial transactions such as granting of loan or providing of security or subscribing to securities in the capital of the related party or may be with respect to appointment of a related party to any office whether as a director or otherwise or for underwriting the subscription of shares, etc. It is therefore necessary to understand the legal provisions as well as the procedural compliances.

SCOPE

This Guidance Note explains the provisions, procedures and compliances for transactions with related parties after considering the following:

1. Companies Act, 2013 read with the Rules thereunder
2. Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015
3. Companies (Auditor's Report) Order, 2016

4. Indian Accounting Standard (Ind AS) 24 – Related party disclosures notified under the Companies (Indian Accounting Standards) Rules, 2015
5. Accounting Standard (AS) 18 – Related party disclosures notified under the Companies (Accounting Standards) Rules, 2006.
6. Secretarial Standards

DEFINITIONS

The following terms are used in this Guidance Note with the meanings specified:

“Act” means the Companies Act, 2013 (Act No. 18 of 2013) or any previous enactment thereof, or any statutory modification thereto or re-enactment thereof and includes any Rules and Regulations framed thereunder.

“Committee” means a Committee of Directors mandatorily required to be constituted by the Board under the Act.

“Listing Regulations” means the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, including any amendment thereto.

“Property” includes property of every description and includes movables, immovables, tangibles and intangibles.

Words and expressions used and not defined herein shall have the meaning respectively assigned to them under the Act, the Listing Regulations and the Secretarial Standards, as may be applicable.

GUIDANCE NOTE

1. Meaning of terms used in the context of transactions with Related Parties

There are a few terms which are used in the Act in the context of related party transactions but these terms are not defined in the Act. The following refer to the context in which these terms have been used or defined in other laws or decided cases.

1.1 'Arrangement'

The definition of term 'agreement' under the Competition Act, 2002 includes any arrangement. Such arrangement may be formal or informal, oral or written and may also be a concerted practice. The term arrangement used in the Act would also have the same interpretation.

In *Ashton v. CIR* (NZ) 75 ATC 6001, their Lordship said that if an arrangement has a particular purpose, then that would be its intended effect and that if it has a particular effect, it will be its intended purpose.

The Hon'ble Bombay High Court, in the case of *Bank of India v. Ahmadabad Manufacturing & Calico Printing Co. Ltd.* (1972) 42 Comp. Cases 211 (Bom), while interpreting the word 'arrangement' as appeared in Section 390 of the Companies Act, 1956, has observed as under:

"The word 'arrange' has, as one of its meaning, in the Shorter Oxford Dictionary, 3rd edition, 'to come to an agreement or understanding', and the word 'arrangement' has, as its primary meaning, 'the action of arranging'. As a matter of plain language it would, therefore, follow that the term 'arrangement' means any agreement or understanding between the parties concerned."

The Hon'ble Division Bench of Karnataka High Court, in the case of *KV Kuppa Raju v. Government of India* (1997) 224 ITR 169 (Mad), has noted that the report of an Expert Group to rationalize and simplify Income Tax law had given the following definition of 'arrangement':

'Arrangement' means any scheme, trust, grant, understanding, covenant, agreement, disposition, transaction and includes all steps by which it is carried into effect.

1.2 'Ordinary course of business'

The Act uses the term 'ordinary course of business', however it does not define the said term.

The ordinary meaning of the expression 'in the ordinary course of business' in dictionaries is 'part of doing regular business; the regular or customary condition or course of things; as things usually happen'.

Black's Law Dictionary defines 'ordinary course of business' as the 'normal

routine in managing trade or business’.

In common parlance, ‘ordinary course of business’ would include transactions which are entered into in the normal course of the business pursuant to or for promoting or in furtherance of the company’s business objectives, as per the charter documents of the company. For example, in case of a manufacturing company, purchase and sale of goods, taking premises on lease/rent, construction of factory, employing workers, etc. will be considered as ordinary course of business. To carry on a business, several activities are carried on by the company; all such activities will be considered to be in the ordinary course of business.

However, if a manufacturing company, for the purpose of diversification, decides to acquire another company which is engaged in a completely unrelated business, this activity will not be considered to be in the ordinary course of business.

To decide whether an activity which is carried on by the business is in the ‘ordinary course of business’, the following factors may be considered:

- a. Whether the activity is covered in the objects clause of the Memorandum of Association
- b. Whether the activity is in furtherance of the business
- c. Whether the activity is normal or otherwise routine for the particular business (i.e. activities like advertising, staff training, etc.)
- d. Whether the activity is repetitive/frequent
- e. Whether the income, if any, earned from such activity/transaction is treated as business income in the company’s books of account
- f. Whether the transactions are common in the particular industry
- g. Whether there is any historical practice to conduct such activities
- h. The financial scale of the activity with regard to the operations of the business
- i. Revenue generated by the activity
- j. Resources committed to the activity

The above list is not exhaustive. Individually, none of the above parameters can amount to the transactions being in the ordinary course of business.

In the case of ***M/s. Bharti Televentures Ltd. v. Addl./Jt. Commissioner of Income Tax*** [ITA 1395/2006, ITA 1656/2010], it was held that the Memorandum and Articles of Association is not conclusive for deciding whether an activity is in the ordinary course of business of the company. Frequency of the activity is sought to be highlighted. It should be a continuous activity carried out in a normal organised manner.

In the case of ***Seksaria Biswan Sugar Factory v. Commissioner of Income Tax*** AIR 1950 Bom 200, the Hon'ble High Court decided that the amount lent by the company to a third party will not be in the ordinary course of business. The Court observed that just because an activity is included in the Memorandum of Association, the activity *per se* does not become an activity in the ordinary course of business of the company.

Note: However, the position will be different based on the facts of the case i.e. if the company is engaged in financial activities or lending to or investing in subsidiaries, associates and joint ventures, the said activities would be considered in the ordinary course of business.

In ***Commissioner of Income-tax and Excess Profits Tax, Madras v. The South India Pictures Ltd.*** (1922) 12 Tax Cas. 427, the assessee had entered into agency agreements for exploitation of three films in question. It was held that entering into such agency agreements for acquiring films was a part of the assessee's business and the agreements in question having been entered into by the assessee in the ordinary course of business, cancellation of those agreements was also a part of the assessee's business and was resorted to in order to adjust the relation between the assessee and the producer of those films.

In other words, any activity which is routine and in accordance with the usual customs and practices of a particular business can be described to be 'in the ordinary course of business'. For a company, the interpretation needs to be contextual, taking into account the nature of the activity and its relevance in the overall context of the company's businesses.

Issue

Who determines that the transaction with related party is in the ordinary course of business? Is it the Board or the Audit Committee?

View

The Act does not clearly lay down tests for determining whether a transaction is in the ordinary course of business.

The Memorandum of Association of the company should be referred to for ascertaining whether the activity is covered in the objects clause therein. This is not a conclusive test but will assist in determining whether a transaction is in the ordinary course of business or not. The Audit Committee may decide whether a particular transaction is in the ordinary course of business and such decision will be based on the policy on transactions with related parties, if any. The company's policy on transactions with related parties should specify the parameters to guide the Audit Committee on whether a transaction is in the ordinary course of business or not. Apart from such a policy, a company may formulate guidelines approved by the Audit Committee and the Board of Directors on transactions with related parties. In such cases, the company can enter into transactions based on the approved guidelines and every transaction need not be placed before the Audit Committee for determining whether the same is in the ordinary course of business or not. In case the company does not have an Audit Committee, the decision as to whether a transaction is in the ordinary course of business or not will be taken by the Board.

1.3 'Arm's length transaction'

Explanation to sub-section (1) of Section 188 of the Act defines the term 'arm's length transaction' as a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.

Arm's length basis does not mean arm's length price as price is just one of the components of the terms of dealing with the other party and there are several other matters which need to be considered. For example, in case of trading of goods, the price charged to both related and unrelated party is Rs. 100 per unit. Based on the price charged, it may seem to be an arm's length transaction. However, if the credit period granted to an unrelated party is 15 days whereas to a related party it is 6 months, it will not be considered as an

arm's length transaction. The transaction as a whole and the entire bundle of the terms and conditions needs to be considered for determining whether the transaction is on an arm's length basis.

In the case of *Ijlin Automotive Private Limited v. Asst. Commissioner of Income Tax* (2011) 16 Taxmann.Com 225, the Court opined that "the determination of 'arm's length price' seeks answer to the question – What would have been the price if the transactions were between two unrelated parties, similarly placed as the related parties in so far as nature of product, and terms and conditions of the transactions are concerned?"

The Bangalore Bench of the Income Tax Appellate Tribunal in the case of *Filtrex Technologies Pvt. Ltd. v. Asst. Commissioner of Income Tax IT (TP) A No. 469/Bang/2017* held that acceptance of arm's length price declared by one party cannot preclude the Revenue from examining arm's length price in the hands of the other party to the same transaction.

Illustration

Suppose company A Ltd. sells a product in the market for Rs. 400 per unit and it also sells the same to its associate company B Ltd. for Rs. 400 per unit and on the same terms of contract as with other parties. Here, the price charged from the associate company and others is the same and the transaction between A Ltd. and B Ltd. is governed by market forces and, therefore, is on arm's length basis.

Arm's length transactions under the Income-tax Act

In terms of Section 92F of the Income-tax Act, 1961, "arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

The term "associated enterprise" as referred to above, is defined in Section 92A of the Income-tax Act, 1961, as under :

"associated enterprise", in relation to another enterprise, means an enterprise –

- (a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- (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