

RELATED PARTY TRANSACTIONS- HARMONISING AND REPORTING UNDER VARIOUS STATUTES

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The “Related Party Transactions” (RPTs) are under heightened watch of various regulators and tax authorities not just in India but globally. The potential to misuse RPTs is a cause for concern all over the world to both regulators as well as investors as has been evident from various scams and frauds in India and globally.

A related-party transaction can also play a favourable role by saving transaction costs and improving the operating efficiency of a company. In other words, all RPTs are not abusive. In fact, there may be several such transactions that are inevitable because they make commercial sense for the company; if companies are prohibited from entering into such transactions, it might work against the principle of maximising the shareholder value.

The reporting and compliance under various different laws poses a challenge as definitions and compliance differ under different statutes and regulations. This article examines the requirements under the different statutes which the companies needs to bear in mind for related party transactions.

The Corporate India’s related party can be summarised as follows:

ACCOUNTING STANDARDS:

As per **Accounting Standard 18-‘Related Party Disclosures’** issued by the ICAI, “Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions” and Related Party transaction means “a transfer of resources or obligations between related parties, regardless of whether or not a price is

charged. The following are the related parties as per AS-18:

(a) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);

(b) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;

(c) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such (individual;

(d) key management personnel and relatives of such personnel; and

(e) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

However, disclosure is mandatory for the following categories of companies:

- i. Companies which are listed or are in process of listing
- ii. Banks, financial institutions and insurance companies
- iii. Enterprises having turnover > Rs. 50 cr.
- iv. Enterprises having borrowings > Rs. 10 cr.
- v. Holding / subsidiary company of any of the above

COMPANIES ACT, 2013:

As per Section 188 of the Companies Act, 2013:

Section 188(1) lists out the related party transactions which is inclusive of transactions done within the meaning of the Old Section 297 and Section 314. In addition, it has also included all related party immovable property transactions. The section is applicable to both Private and Public companies and is effective from 1st April, 2014. The Rules attached to Section 188 imposes more compliances on certain classes of Companies and certain types of transactions.

As per Rule 15(3) of the Companies (Meetings of Board and its Powers) Rules, 2014:

For the purposes of first proviso to sub-section (1) of section 188, except with the prior approval of the company by a special resolution-

(i) a company having a paid-up share capital of ten crore rupees or more shall not enter into a contract or arrangement with any related party; or

(ii) a company shall not enter into a transaction or transactions, where the transaction or transactions to be entered into—

(a) as contracts or arrangements with respect to clauses (a) to (e) of sub-section (1) of section 188 exceeding twenty five percent of annual turnover in case of sale, purchase of goods and material and ten per cent of net worth in case of selling or otherwise disposing of, or buying, property of any kind directly or through appointment of agents, leasing of property of any kind and availing or rendering of any services directly or through appointment of agents

(b) appointment to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding two and half lakh rupees as mentioned in clause (f) of sub-section (1) of section 188; or

(c) remuneration for underwriting the subscription of any securities or derivatives thereof of the company exceeding one percent of the net worth as mentioned in clause (g) of sub-section (1) of section 188.

Here also the member interested in the resolution cannot vote on the resolution. However, no central Government permission is required. The new Act has not given any solution or remedy if all the board members are interested and similarly all members are interested and there is no requisite uninterested quorum. In such situation there is no remedy available with the Company except to appoint independent directors or non related members as the case may be.

The most welcome part of related party is exemption to transactions which are made in the ordinary course of business made on arm's length. The onus to prove that the particular transaction is on arm's length basis is on the Company. The Companies (both private and Limited and even listed Companies) can avail the benefit of these provisions. The ordinary course of business means the Company regularly carries on business or regularly trades in such field and the expression "arm's length transaction" means a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.

Pursuant to the provisions of Section 134(3)(h) of the Act, the Company is also required to disclose the particulars of contract or arrangement with related parties in the Board of Director's report which was not earlier. Moreover, as per rule 15(2) of Companies (Meetings of Board and its Powers) Rules, 2014, in case the Holding Company passes the special resolution in respect of related party transaction with its wholly owned subsidiary company, then it shall be sufficient compliance.

"Related Party" is defined as per Section 2(76) of the Companies Act, 2013. This definition is wider than the definition of erstwhile Act. The relative of key

managerial person, persons accustomed to act on directors, associate company etc. are new provisions which is also a good step to plug the loop holes.

Definition of Relative:

As per Section 2(77) of the Companies Act, 2013:

“Relative”, with reference to any person, means anyone who is related to another, if—

- (i) they are members of a Hindu Undivided Family;
- (ii) they are husband and wife; or
- (iii) one person is related to the other in such manner as may be prescribed;

Besides above, the following are considered relative(s) including the step relationship Father, Mother, Son Son’s wife Daughter Daughter’s husband Brother Sister.

The number of relatives comparing list given in the erstwhile Act have been reduced which is also a welcome step. However, there is one practical problem with directors in knowing the firms or companies or percentage of holding in which their relatives are interested.

Income Tax Act, 1961:

Section 2 (41) "relative", in relation to an individual, means the husband, wife, brother or sister or any lineal ascendant or descendant of that individual ;

As per Section 40A (2) (a) Where the assessee incurs any expenditure, in respect of which payment has been made or is to be made to certain specified persons (i.e., relatives or close associates of the assessee), and the Assessing Officer is of the opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived or accruing to him therefrom, so much of the expenditure, as is so considered by him to be excessive or unreasonable, shall not be allowed as a deduction.

40 A 2 (b) The persons referred to in clause (a) are the following, namely:—

(i) where the any relative of the assessee is assessee; an individual

(ii) where the any director of the assessee is a company, partner of the company, firm, firm, or member of the association of association or family, or persons or any relative of such Hindu undivided director, partner or family member;

(iii) any individual who has a substantial interest in the business or profession of the assessee, or any relative of such individual;

(iv) a company, firm, association of persons or Hindu undivided family having a substantial interest in the business or profession of the assessee or any director, partner or member of such company, firm, association or family, or any relative of such director, partner or member [or any other company carrying on business or profession in which the first mentioned company has substantial interest];

(v) a company, firm, association of persons or Hindu undivided family of which a director, partner or member, as the case may be, has a substantial interest in the business or profession of the assessee; or any director, partner or member of such company, firm, association or family or any relative of such director, partner or member;

(vi) any person who carries on a business or profession,—

(A) where the assessee being an individual, or any relative of such assessee, has a substantial interest in the business or profession of that person; or

(B) where the assessee being a company, firm, association of persons or Hindu undivided family, or any director of such company, partner of such firm or member of the association or family, or any relative of such director, partner or member, has a substantial interest in the business or profession of that person.

Explanation—For the purposes of this sub-section, a person shall be deemed to have a substantial interest in a business or profession, if,—

(a) in a case where the business or profession is carried on by a company, such person is, at any time during the previous year, the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) carrying not less than twenty per cent of the voting power; and

(b) in any other case, such person is, at any time during the previous year, beneficially entitled to not less than twenty per cent of the profits of such business or profession.

Form 3CD- Tax Audit:

In tax audit report, an auditor is required to give particulars of payments to persons specified under section 40A(2)(b) under Clause 23 of the Form 3CD(Tax Audit Report). He is not required to give his opinion on the unreasonability/excessiveness of the payments. That is the Assessing Officer's prerogative only.

According to ICAI's Guidance Note, the tax auditor should apply the following procedures in respect of this clause:

(a) Obtain full list of specified persons as contemplated in section 40A(2)(b).

(b) Obtain details of expenditure/payments made to the specified persons.

(c) Scrutinise all items of expenditure/payments to the specified persons.

(d) As locating all such payments would be difficult and time consuming, localise the area of enquiry as follows:

I. Call for all contracts or agreements entered into by the assessee and list out the contracts or agreements entered into with the specified persons and segregate the items of payments made to them under these agreements.

II. In case of payments for purchases and expenses on credit basis, scrutinize the appropriate ledger accounts to identify the dealings with the specified persons.

III. In case of cash purchases and expenses, scrutinize the purchase or expense account. It may be necessary to restrict the scrutiny only to such payments in excess of certain monetary limits depending upon the size of the concern and the volume of business of the assessee.

IV. In case of a large company, it may not be possible to verify the list of all persons covered by this section. Therefore, as per Circular No. 143, dated 20-8-1974, issued by the Board, clarifies that tax auditor can rely upon the list of persons covered under section 13(3) as given by the managing trustee of a Public Trust.

The information to be disclosed in clause 23 can be found easily from the Related Party Disclosures under AS 18 in the Notes to Accounts of Audited Financial Statements as tax audit is normally conducted after statutory audit. However, the related parties as per AS 18 and the persons covered u/s 40A (2)(b) are not completely the same. It is to be noted that in Section 40A (2)(b), the words “substantial interest” have been given for determination of relationship of parties. Whereas in AS 18, the words “Significant Influence” is of importance which comes not only from substantial interest but also from statute or agreement and it means participation in financial/operating policy decisions of the enterprise.

It is also to be noted that the definition of the term "relative" in Income Tax Act is wider than as given in AS 18 as it also includes any lineal ascendant or descendant, i.e., even grandfather, grandmother, great grandfather or grandmother, grandchildren or great grandchildren and so on.

Impact of Domestic Transfer Pricing w.r.t Payment to persons specified u/s 40A(2)(b)

Specified Domestic Transactions inter alia include expenditure in respect of which payment has been made or to be made to a person specified u/s 40A(2)(b) provided the aggregate amount of all the specified domestic transactions exceed Rs. 5 Crore in the financial year. Transfer Pricing regulations have been made applicable with effect from 01.04.12 wherein the Company entering into Specified Domestic Transactions has to maintain certain documents regarding nature of such transactions, record of uncontrolled transactions for comparability, determination of Arm's Length Price, record of method used to calculate Arm's Length Price, etc. and has to ensure that the transactions are made at Arm's Length Price. It would also be required to obtain a report from Chartered Accountant in form 3CEB before the specified due date i.e., 30th November.

Moreover, under Section 40A, the Assessing Officer has been given power to disallow so much of expenditure as appears excessive or unreasonable having regard to fair market value, legitimate needs of business or benefit derived by the assessee as a result of such expenditure. However, Finance Act 2012 has inserted a proviso to sub section 2(a) which says that no disallowance shall be made for expenditure in respect of Specified Domestic Transactions if such transaction is at Arm's Length Price.

Clause 49 of Listing Agreement

Securities and Exchange Board of India ("SEBI") has overhauled the existing Clause 49 of the Listing Agreement and replaced it with a revised Clause 49 (the "New Clause" or the "Clause"). The New Clause, which will be effective from 1 October 2014, serves the following objectives: align the provisions of Listing Agreement with the provisions of the newly enacted Companies Act, 2013 and also provide additional requirements to strengthen the corporate governance framework for listed companies in India. However, certain requirement under the New Clause goes a step further and imposes more stringent requirements of corporate governance to listed companies.

For the purpose of Clause 49 (VII), an entity shall be considered as related to the company if:

- (i) such entity is a related party under Section 2(76) of the Companies Act, 2013; or
- (ii) such entity is a related party under the applicable accounting standards."

The New Clause is based on the principle of ensuring equitable treatment to all shareholders and recognising the rights of all stakeholders in the company. It provides that all material RPT requires prior approval of the shareholders through a special resolution and the related parties are prohibited from voting such resolutions. Mandating the approval of RPT by the majority of the shareholders who are not interested in the transactions can curb abusive RPT. As per Sebi, any transaction with a related party that exceeds 10 percent of the Consolidated Annual Turnover of the Company on the basis of latest audited financial statement would be considered "material". It may be noted that pre-amendment Clause 49 had two thresholds, the higher of 5 per cent of the annual turnover or 20 per cent of the net worth of the Company.

Audit Committee has been entrusted with the role of preventing the abusive RPT. Currently, the Audit Committee reviews RPT on a periodical basis. The

periodical reviews do not serve much purpose as a transaction already carried out cannot be undone. Hence, the New Clause provides that all RPT requires prior approval of Audit Committee.

The New Clause also widens the definition of RPT significantly. Even a transaction between related parties without any charge has been included in the definition of RPT. The clause shall be applicable to all prospective transactions. The Clause requires that all material RPTs have to be disclosed in the quarterly compliance report on corporate governance.

Conclusion

The requirements of Companies Act 2013, Sebi norms and Accounting standards with respect to related party are not aligned to each other. Companies Act, 2013 requires disclosure at the time of entering into contract or arrangement whereas accounting standard requires disclosure at the time of entering into a transaction. Clause 49 adds new class of related parties to the definition thereof given under the Act and includes close family members, fellow group entities, joint ventures of same third party and combinations thereof, which are not in accounting standard or the Companies Act. Revised clause 49 requires shareholders' approval for all material related party transaction with no exception for transactions in ordinary course of business or at arms-length. Definition of material transactions differs.

Thus, the related party transactions (RPT) are widespread and are part and parcel of every business group activity, particularly in emerging markets. RPT between group companies can result in both positive and negative effects for the investor. RPTs may help achieve effective asset utilization as well as reduce transaction cost or diversify risks.