

CHAPTER 4: IMPORTANCE OF CORPORATE GOVERNANCE IN RELATED PARTY TRANSACTIONS AND TRANSFER PRICING

CORPORATE GOVERNANCE IN RELATED PARTY TRANSACTION	141
<i>TRANSFER OF TANGIBLE ASSETS</i>	144
<i>TRANSFER OF INTANGIBLE ASSETS</i>	144
<i>SALES OF SERVICES</i>	144
<i>FINANCING ACTIVITIES</i>	145
<i>ANALYSIS OF SECTION 188 OF COMPANIES ACT, 2013</i>	148
<i>Identification of related parties</i>	149
<i>Identification of related party transactions</i>	150
<i>Approval process</i>	150
<i>Disclosure requirement</i>	154
<i>PROVISION FOR RELATED-PARTY TRANSACTIONS UNDER CUSTOMS ACT, 1962</i>	155
<i>PROVISION FOR RELATED-PARTY TRANSACTIONS UNDER INCOME TAX ACT, 1962</i>	156
<i>Issues</i>	156
<i>Disclosure norms</i>	157
<i>Exemptions/Non-applicability</i>	158
<i>INTERNATIONAL TRANSACTIONS COVERED UNDER 92 OF INCOME TAX ACT, 1961</i>	159
<i>RESEARCHER'S VIEW ON THE EFFICACY OF CURRENT SYSTEM</i>	160

CORPORATE GOVERNANCE IN RELATED PARTY TRANSACTION

Prices charged for inter-unit transfer of goods and services are termed as "Transfer Pricing". Therefore, it is apparent that related parties are involved in all such inter-unit transactions. Investors and market observers are concerned that transactions with related parties are harmful to company shareholders¹⁴¹. Revenue authorities are concerned that Corporates are in a position to evade taxes by using the transfer pricing mechanism which will result in loss to the exchequers. Related Party Transactions are most contentious issues globally and therefore are under scrutiny by regulators globally. RPTs have been identified as one of the major causes for corporate frauds recently, such as Satyam, Enron, Adelphia, and many others. Uninfluenced pricing of goods and services is crucial in related party transaction to prevent abuse of the pricing methodology. However, since the transactions are entered into by the internal units of the same Group, the independence of prices charged by the one unit of the group to the other unit of the same group are not passed through the same scrutiny and comparative analysis of the prices to be paid, as it would have passed through for any transactions with unrelated parties. The researcher has observed that in most of the cases, the prices charged for such related party transactions are governed by the internal policies of the Group. Therefore, to protect the interest of all the stakeholders, appropriate Corporate Governance within the Group is important. A concern in relation to poor

¹⁴¹ These are kind of relationships that companies should avoid, in the view of some corporate-governance experts and investors. Such related party transactions raise question about whether corporate insiders are fully focused on interest of shareholders, expert says. The deals, no matter how small, can create the impression that an insider is using company assets for personal benefit, and that the company is getting the short end of the stick. See, *Even Good Insider deals raise doubts*, WALL STREET JOURNAL B6 (May 7, 2003)

corporate governance is the abuse of related party transaction. In case of related party transaction in a controlled environment, be it is Company with concentrated¹⁴² ownership or a MNC group, increases the probability of abuse if not conducted at arm's-length. To protect all stakeholders¹⁴³ from abuse of related party transaction, an appropriate corporate governance process is needed to be established by all companies.

OECD had mentioned in its article published in 2004¹⁴⁴ that related parties may include entities that controls or are under common control with the company, significant shareholders including members of their families and key managerial personnel. Transactions involving the major shareholders, relatives, are mostly complex transactions to unravel the possibilities of abuse. The related party transactions are entered in a controlled environment where one of the parties has ability to control or influence the other in deciding the commercial terms of the transactions. OECD further commented in this article that an efficient corporate governance framework should be able to promote transparent and efficient markets, which should be consistent with the rule of law of the country. OECD also clearly articulated the division of responsibilities among different supervisory, regulatory and enforcement authorities. The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Functioning of a company needs to be reviewed for establishment of fair transfer pricing for all related party transactions. Board of Directors should take independent decision which should be fare in all perspective. The Board should treat all the shareholders fairly. Board

¹⁴² Concentrated Ownership is a common and widespread use of a company groups is a common feature in India, where most companies are closely held by families or state

¹⁴³ With regard to Transfer pricing, stakeholders includes revenue authorities and other statutory establishment

¹⁴⁴ <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf> (Last accessed on Sept.22, 2015)

members should be adequately informed and take utmost care before acting or approving any such decision which might be detrimental to any of the stakeholders. Some contentious decisions which may be detrimental to the interest of the stakeholders other than majority shareholders are listed below:

- 1) Launch of new Services/Product and decision of changing product mix to favour another group entity
- 2) Discontinuation/Slowdown of production to ensure higher capacity utilization of another group entity
- 3) Reducing the scale of operation after merger/takeover of another Company
- 4) The charges paid to associated enterprises for various services without comparing the prices with independent service providers.
- 5) Providing Management support to some other entities at free of cost
- 6) Engaging common consultants at fairly higher cost
- 7) Participation in purchase contract with a global vendor to pass on benefits with related to volume to group entities
- 8) Influenced commercial contracts with associated enterprises resulting into losses
- 9) Rolling out a group based hedging policy whereby the entity, which is net importer, sustains losses during exchange rate volatility, whereas the entity which is a net exporter within the same group gains from this policy.
- 10) **Shareholders service**¹⁴⁵ refer to those services where the fee charged by the related companies for the services rendered by the related parties cannot be considered as service for the benefit of service recipient. The situation arises when the services rendered by

¹⁴⁵ Referred to Shareholders Activity as defined in BEPS Action 10: Proposed modifications to Chapter VII of the Transfer Pricing guidelines relating to low value-adding intragroup services, *available at* <http://www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-low-value-adding-intra-group-services.pdf> ((Last accessed on December 26, 2014)

the service providers mainly cater to the requirement of the shareholders for controlling the activities of the local unit. These types of services are considered as "shareholders services". Generally allocation of corporate charges and headquarter charges can be considered as shareholders service in absence of any detail of service received.

Apart from the strategies and decisions, as discussed above, which may be detrimental to stakeholders, the following transactions, in absence of arm's length pricing, may be also detrimental to the stakeholders.

Transfer of Tangible Assets

Raw materials, work in progress and finished goods are mainly transferred between related parties. Sale of fixed assets also comprises the part of the inter-Company transactions.

Transfer of Intangible Assets

Amongst various types of intangible assets, Patents, trademark, brands, capability of service and Intellectual property forms a major portion of the transactions entered into by the related parties. Intangible assets are mainly created for generating future economic benefits. These assets are capable of being protected by legal rights.

Sales of Services

Services range from simple shared services which include but not limited to accounting, legal or tax, to complex technical support. Various types of services that are rendered by related parties are:-

- a) Simple service like accounting, tax, legal etc.
- b) Technical assistance for transferring manufacturing intangibles.
- c) Technical services like manufacturing, quality control, or marketing.
- d) Management support by expat employees for management of facilities which can be considered as transfer of knowledge or services.
- e) In case of a new acquisition, the facility can require support of the group companies. In that case all types of activities mentioned above can exist.

Financing activities

Financing activities include financing short term and long term capital needs.

Methods for financing short term working capital requirement may consist of:-

- a) Payment terms for the goods and services rendered
- b) Advance payment for purchase of capital goods
- c) Beneficial credit term for the related parties
- d) Extending guarantee to third parties for obtaining loan

Financing long-term capital needs may include:-

- a) Mortgages
- b) Lease financing
- c) Capital Stock
- d) Long term debt
- e) The issue of various financial instruments

f) Long term intercompany loans

Table 5: Aggregate of Related Party Transactions of 50 Companies

Extracts from aggregate of Related Party Transactions of 50 Companies as a percentage of net worth 2008-09
source : Related Party Transactions and Minority Shareholders right, OECD 2012

Category	Related Party Transaction as a percentage of net worth								Grand Total
	Associates	Subsidiary	Key Managerial Person	Relatives	Joint Venture	Individual	Other Company	Holding Company	
Accounts Payable	0.02	0.79	0.05	0.00	0.00	0.00	0.88	0.00	1.74
Advance given	0.01	0.94	0.00	0.00	0.32	0.00	0.18	0.00	1.45
Corporate Guarantee	1.36	18.81	0.00	0.00	0.37	0.00	0.24	0.00	20.78
Loans and Advances G	0.50	25.11	0.00	0.00	0.54	0.00	1.11	0.00	27.26
Purchase of Goods & S	2.44	3.36	0.00	0.00	1.81	0.00	4.77	1.92	14.30
Sale of Services	0.37	11.09	0.00	0.00	0.28	0.00	5.00	0.21	16.95
Investment made	2.02	5.71	0.00	0.00	0.14	0.00	1.22	0.01	9.12

All the above decisions and related party transactions which are transacted in a controlled environment may results into losses for the entity which will ultimately impact the valuation of the share prices. The researcher has observed that these decisions and transactions may be value destroying such as tunneling and squeeze out.¹⁴⁶

However, it is noted by the researcher during various case studies that all related party transactions are not aimed or result into decrease in shareholders' value. Some of these genuine transactions are entered to save cost and to improve efficiency by availing the resources available within the group. Hence restricting these transactions in anticipation of abusive transactions will be detrimental to the shareholders.

Therefore the researcher would like to submit that to protect the interest of the stakeholders, the independence of the Board for ensuring that related

¹⁴⁶ Tunneling covers transactions where a controlling shareholder or Key Managerial person enters into a transaction for a personal gain. The controller gains and minority shareholders losses opportunity to increase their values in such transactions. Squeezing out are those situations where the controlling shareholder merge the unit to takeover the minority shareholding interest just before the unit become profitable.

party transactions are done in an uncontrolled environment, will be critical. In its guideline ¹⁴⁷, OECD has recommended certain key functions to be performed by Board of Directors, which are listed as below:-

1. Reviewing and guiding corporate strategy, major plan of actions, risk policy, annual budgets and business plans, setting performance objectives, monitoring implementation and corporate performance, and overseeing major capital expenditures, acquisition and divestitures;
2. Monitoring the effectiveness of the company's governance practices and making changes as needed;
3. Selecting, compensating, monitoring and when necessary, replacing key executives and overseeing succession planning;
4. Monitoring and managing potential conflicts of interest including abuse in related party transaction.

The corporate governance framework in relation to related party transaction should ensure timely disclosure about related party transactions, ownership and voting rights, independence of Board by way of disclosure of interest by the members of the Board. The OECD-Asian Roundtable Task Force published a Guide to fighting abusive related party transactions in Asia (2009)¹⁴⁸. This report acknowledged that not all Related Party Transactions are abusive. It is recommended in the guide that a balance should be strike between abusive related party transactions and unfair regulatory burden on the companies which ultimately increases the cost for the business. The guide further suggests the following criteria for abusive related party transactions:-

¹⁴⁷ *OECD Principle On Corporate Governance*, (OECD, 2004) Available at <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf> (Last accessed on March 10, 2015)

¹⁴⁸ *Improving Corporate Governance in India* (OECD, 2014) available at <http://www.oecd.org/daf/ca/Improving-Corporate-Governance-India.pdf> (Last accessed on December 10, 2015)

- a) Parties involved in the transaction
- b) Type of transactions
- c) Pricing mechanism for the transaction
- d) Compensation paid for the transaction
- e) Why this transaction is done and the timing of transaction
- f) Whether there is a potential conflict of interest

Considering the importance of related party transactions to protect the interest of exchequers and minority shareholders, Indian regulators has enacted separate rules and regulations to curb abuse of related party transactions under various statutes. The main aim of these regulations are to promote investor protections, particularly that of minority shareholders. Some of these regulations are briefly discussed in the following sections.

Analysis of Section 188 of Companies Act, 2013

Since number of listed Companies in India is significant and the transactions are increasing, the regulators in India is continuously pursuing to strengthen then corporate governance since 1998 when it has implemented a substantial regulation for corporate governance which was one of the best practices in Asia. The statistics¹⁴⁹ shows that there has been an increasing trend of related party transactions. These regulations were further improved in 2004 in relation to the role of independent directors and audit committees. However, the Satyam fraud¹⁵⁰ in 2008 which also involved a contentious

¹⁴⁹ In working paper no 402 titled "An analysis of related-party transactions in India", by Padmini Srinivasan, published in 2013, it was found that transactions with subsidiary companies accounted for 64% (average) of all RPTs. Other prominent related parties with whom transactions were held were associates (8.36%) and holding companies (8.73%). The related party transactions for 137 companies surveyed for the study reported related party transactions of INR 477857 crore in 2009 and INR 613761 crore in 2011149.

¹⁵⁰ Controlling Shareholder (i.e., promoter) of Satyam: Ramalinga Raju informed the exchange on December 16, 2008 that the Board of Satyam Computer Services Limited in its meeting has unanimously approved a proposal to diversify its business and accorded its approval to acquire 100% stake in Maytas Properties Limited and 51% stake in Maytas

related party transaction that was approved by independent directors indicated a need of further measures.

In its continuous efforts to strengthen the corporate governance, Government of India has enacted a new Companies Act in 2013. The statute has prescribed various disclosure norms and has placed more reliance on the same than on approvals. Under Companies Act, 1956, approvals of Central Government was necessary for large Cap companies whereas under Companies Act, 2013, disclosure with member's approval for such transactions are prescribed. This new section of the Companies Act, 2013 might be divided into four segments which is analysed in detail as below.

Identification of related parties

Definition/Meaning of Related Party under Section 2(76) of Companies Act 2013, read with relevant rules made thereunder, defines a related party as under:

Table 6: Related Party

Individuals	Other than Individuals
<ul style="list-style-type: none"> • a director or his relative 	<ul style="list-style-type: none"> • a firm, in which a director, manager or his relative is a partner • a private company in which a

infrastructure limited which would result in a total cash outflow of \$ 1.6 billion. Ramalinga Raju group held 8.6% in Satyam Computers, 39.64% in Maytas Infrastructure and Maytas properties was an unlisted company held by Ramalinga Raju group. This action was questioned by investor community and media. The share prices fell almost 55% in NYSE from its previous day since this was not explained in press note that why a technology company would venture into infrastructure sector by paying a huge consideration which is held by the controlling shareholders. Subsequently Satyam made an announcement of renouncing their earlier decision. On 25th December one of the independent directors resigned from the Board and had informed that she voiced her reservation about this transaction in the board meeting, but failed to cast dissenting vote to ensure that her views were put on records. It was further identified that one of the independent director was acting as a consultant for the company and her remuneration was almost seven times more than the market rate and that of other directors.

<ul style="list-style-type: none"> • a KMP or his relative • a director or KMP of the holding, subsidiary or associate company of such company or his relative • any person appointed in senior management in the company or its holding, subsidiary or associate company • any person on whose advice, directions or instructions a director or manager is accustomed to act 	<p>director or manager is a member or director</p> <ul style="list-style-type: none"> • a holding, subsidiary or an associate company • fellow subsidiary • a public company in which a director or manager is a director or holds along with his relatives, more than 2% of its paid-up share capital • any body-corporate whose BODs, MD or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager
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Identification of related party transactions

In accordance with Section 188(1)¹⁵¹ of the Companies Act, 2013, the following transactions with related party needs appropriate approval as per approval matrix based on nature of transaction in the said act. Any transaction between a company and its related party relating to:

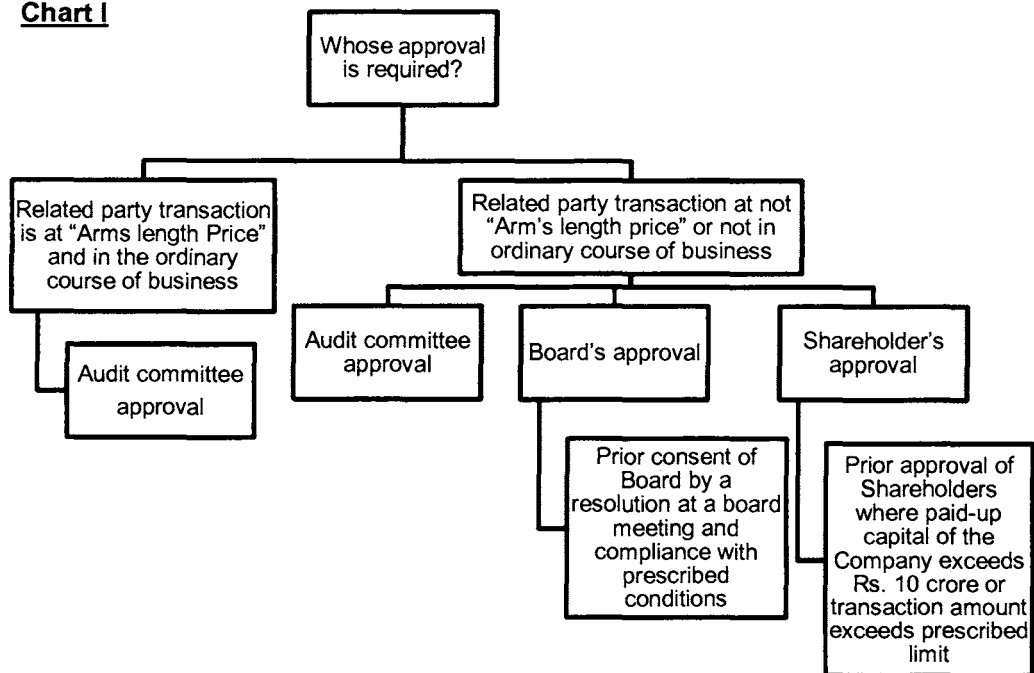
- a) sale, purchase or supply of any goods or materials;
- b) selling or otherwise disposing of, or buying, property of any kind;
- c) leasing of property of any kind;
- d) availing or rendering of any services;
- e) appointment of any agent for purchase or sale of goods, materials, services or property;
- f) such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and
- g) Underwriting the subscription of any securities or derivatives thereof, of the company.

¹⁵¹ Companies Act 2013, available at [www.mca.gov.in/Ministry/pdf/Companies Act2013.pdf](http://www.mca.gov.in/Ministry/pdf/Companies_Act2013.pdf) accessed on 22.5.2013

Approval process

Section 188(1) of the Companies Act, 2013 listed the following approval matrix is suggested

Chart I



It is important to note here that, for the first time, regulators have recognized the importance of Arm's length relationship for related party transactions. Explanation (b) was inserted in Section 188(1) of the Companies Act, 2013 to define "arm's-length transaction" as transactions in an uncontrolled environment and without any conflict of interest. A company may use guidance under International and domestic taxation for determination of arm's length principle. However, determination of arm's length principle is subjective and need detailed analysis of the transaction. Hence, the board

should take enough care to approve a transaction which is perceived as “arm’s length principle” compliant¹⁵².

Compared to the earlier approval process, the Companies Act, 2013 has placed more reliance on self-governance and therefore no Central Government’s approval is now required. This self-governance concept has placed more accountability on the Board and controlling shareholders. In accordance with the said act, no member of the company shall vote on such special resolution, to approve any contract or arrangement which may be entered into by the company, if such member is a related party.

“Ordinary course of business” is not defined in Companies Act, 2013 or rules made thereunder. Few transactions listed below may be considered as outside normal course of business:-

- i. Complex equity transactions such as corporate restructuring or merger
- ii. Transaction with offshore entities. The leasing of premises or the rendering of management services without any consideration
- iii. Sales transactions with large discounts
- iv. Transactions with circular arrangements¹⁵³
- v. Transactions under contracts whose terms are changed before expiry

The approval matrix provided in this section requires that identification of ordinary course of business is subjective and may vary on case-to-case basis. Therefore, careful consideration is required to identify a transaction as conducted in ordinary course of business.

¹⁵² For example, how to determine arm’s length pricing for services obtained from a group company without comparing the charges or if the charges are relatively higher than any other company. Whether principle of business prudence will justify in this case?

¹⁵³ For example, sales with a commitment with repurchase.

In case of wholly owned subsidiary, the special resolution passed by the holding company shall be sufficient for the purpose of entering into the transactions between wholly owned subsidiary and holding company.

In accordance with the s.188(3) of the Companies Act, 2013, in case any transaction is entered into without the consent of the appropriate authorities as mentioned above, the transactions need to be ratified by the appropriate authorities within 3 months from the date of entering into the transactions. In case no ratification is done within the prescribed time limit, the transaction will be voidable at the option of the Board and the director will indemnify the Company for the losses sustained by it. Further in accordance with s.188(4) of the said act, the Company shall be able to proceed against the director or any other employee who had entered into such contract or arrangement in contravention of the rules prescribed under the act.

To make the employees and directors, who are responsible for executing the contracts, more accountable, s.188(5) prescribed a stringent penalty for violation of this Act as below:-

- i) In accordance with s.188(5)(i) of the Companies Act, in case of listed Companies, for any violation of this section, the offender employee or the director will be punishable with imprisonment for a term upto one year or a fine between twenty five thousand and five lakhs, or with both
- ii) In case of non-listed companies, the offender will be punishable only with fine

Disclosure requirement

Every related party transaction or contract shall be disclosed in the Board's report along with the justification for entering into such contract or arrangement. Also the statement of related party transactions should be produced before shareholders in a general meeting, wherever applicable. It is also required as per the Act and Rules made thereunder that interested shareholders and directors should abstain from approval process.

Although Companies Act, 2013 encompasses almost all related party transactions, to protect the interest of minority shareholders and to ensure that transparency and independence is maintained in transactions with related parties. However, the independence of the Board is critical to ensure enforcement of the statute. The selection and composition of the Board will be important to maintain its independence.

Although Companies Act, 2013 covers a large section of related party transactions, the interest of revenue as a stakeholder will not be fully protected by this Act in all circumstances. The provision of related party transactions will be applicable in case both the transacting companies are registered under Companies Act, 2013 or earlier Act. Therefore, transactions entered by a Company in India with an overseas associated company will not fall under the purview of the Act. Also the transactions with related parties within a group, which is not subsidiary or holding company, and there is no common directors, will not be covered under this Act¹⁵⁴. Hence the rules and

¹⁵⁴ For example, X Ltd, Y Pvt. Ltd and Z Pvt. Ltd are sister concerns, all are registered under Companies Act, 1956. 97.5% of shares of X Ltd is held by E Ltd, Mauritius and remaining is held by various minority shareholders. The holding company of Y Pvt. Ltd is E Ltd, Singapore, whereas the Z Pvt. Ltd is held by E Corporation, US. All the companies, E Ltd, Mauritius E Ltd, Singapore and E Corporation, US are ultimate subsidiary of E PLC, UK. Mr S and Mr N, employee of Y Pvt. Ltd are Directors of X Ltd. There are significant transactions between X Ltd and Z Pvt. Ltd. In this circumstance, the transactions are not

regulations of this Act will not be applicable on all those transactions. Hence, to secure the interest of the revenue, rules and regulations were inserted in various other statutes. Some of the relevant statutes are analysed herein below.

Provision for Related-Party transactions under Customs Act, 1962

The relationship between the importer and exporter could have a serious implication on the value declared for the customs purpose. Sub-rule 3(a) of the Customs (Determination of value of imported goods) Rule 3, 2007 states that in the case of imports by related person, transaction value shall be accepted provided the relationship did not influence the price. There are situations where a relationship could be alleged to influence the transaction value declared in the bill of entry. Such situations are:-

- (i) The importer being relative of the exporter
- (ii) The importer company having a technical know-how agreement with the exporter company
- (iii) Financial collaboration between the transacting parties with or without technical collaboration
- (iv) Importer company being the subsidiary of the exporter company
- (v) Importer and exporter company being subsidiary of the foreign company
- (vi) Any other relations which can be termed as related party transaction under the Act

In all such cases where a relationship exists between the importer and exporter of the goods, the customs department refers the matter to Special Valuation Branch (SVB) for an investigation. In *CC v. East African Traders*¹⁵⁵,

covered under provision of s.188 of Companies Act, 2013. Hence the transparency in these transactions cannot be assured only under the provisions of Companies Act.
¹⁵⁵ 2000 (115) ELT 613 (SC)

the Apex court held that it was permissible for the customs authorities and the Tribunal to pierce the veil of the importing company to determine whether or not the latter were “related party”.

Provision for Related-Party transactions under Income Tax Act, 1962

Transactions covered under 92BA of Income Tax Act, 1961– Domestic Transfer Pricing in specified domestic transactions. Specified domestic transactions (SDT) ¹⁵⁶means:-

- a) Any expenditure in favour of person mentioned in section 40A(2)(b)
- b) Transaction listed in section 80A
- c) Transactions listed in section 80 IA(8)
- d) Any business transaction referred to in section 80 IA(10)
- e) Any other transaction listed under chapter VI-A or section 10AA to which provisions of section 80-IA are applicable or
- f) Any other transactions as may be prescribed

The section applies to aggregate of transactions exceeding rupees five crore in the previous year. Domestic Transfer Pricing (DTP) has posed a new challenge for taxpayers, given onerous documentation requirement and challenges in applying the provision to tax holidays undertaking. Further benchmarking of payments to directors goes beyond the ‘arm’s length principle (APL)”

Issues

Applying any of the transfer pricing methods for payment to Directors poses a challenge since payments vary across companies and depend on a

¹⁵⁶ Available at <http://www.incometaxindia.gov.in/Pages/acts/income-tax-act.aspx> (Last accessed on April 24, 2014)

combination of factors. These factors include role, functions and qualification of a particular director, each company's ability and capacity to pay. Specific needs to each company and cannot be benchmarked or compared. Furthermore, the payments by any company to its directors cannot be compared to payments made by any other company to its directors since payments to directors by any company are always controlled related party transactions and DTP provision pre-suppose the use of uncontrolled transactions to establish comparability.

Section 80-IA(8) "Transfer of goods and services" with other undertakings of the same taxpayer need to be undertaken at arm's length, computer with reference to prescribed transfer pricing methods.

Section 80-IA(10) Tax holiday benefit is disallowed in case where the assessing officer believes that the profit are more than 'ordinary' due to close connection with any other person or due to any other reason. 'Ordinary' profits needs to be determined with reference to ALP.

Disclosure norms

Disclosures to be made in notice calling Board Meeting:

- a. name of the related party and nature of relationship;
- b. nature, duration of the contract and particulars of the contract or arrangement;
- c. material terms of the contract or arrangement including the value, if any;
- d. any advance paid or received for the contract or arrangement, if any; and

- e. any other information relevant or important for the Board to take a decision on the proposed transaction.

Disclosures to be made in the explanatory statement to be annexed to notice of general meeting:

- a. name of the related party ;
- b. name of the director or key managerial personnel who is related, if any;
- c. nature of relationship;
- d. nature, material terms, monetary value and particulars of the contract or arrangement;
- e. any other information relevant or important for the members to take a decision on the proposed resolution.

Disclosures to be made in Board's Report:

Exemptions/Non-applicability

The above mentioned provisions will not be applicable in case of transactions entered into by the company in its ordinary course of business, which are on arm's length basis¹⁵⁷. Consequences of non-compliance are:

- i. If any related party transaction or contract is entered without seeking Board's and/or Members' approval and if the same is not ratified by the Board and/or Members as the case may be, within 3 months at a meeting, then the contract or transaction will be voidable at the option of the Board and if the transaction is with any related party to any director or is authorised by any other director,

¹⁵⁷ "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.

then the concerned directors are liable to indemnify any loss incurred by the company.

- ii. Additionally, the company can also proceed against a director or employee who had entered into such contract or arrangement in contravention of the provisions of this section for recovery of any loss sustained by it as a result of such contract or arrangement.
- iii. Any director or any other employee of a company, who had entered into or authorised the contract or arrangement in violation of the provisions of this section shall –
 - a. in case of listed company, be punishable with imprisonment for a term which may extend to 1 year or with fine which shall not be less than Rs. 25,000/- but which may extend to Rs. 5,00,000/-, or with both; and
 - b. in case of any other company, be punishable with fine which shall not be less than Rs. 25,000/- but which may extend to Rs. 5,00,000/-.

International Transactions covered under 92 of Income Tax Act, 1961

The related parties for the purpose of this section are defined as “associated enterprises”. Section 92(3) of the Income Tax Act, 1961 stipulates that any transactions between two or more associated enterprises should be done at “arms-length” price. The associated enterprise for the purpose of this section is listed in Section 92A of the said Act. The definition of associated enterprises and arms-length pricing is discussed in multiple sections of Chapter 1 (Key Concepts).

The provisions to regulate the International Transactions are quite comprehensive and detailed. With increasing volume of international transactions, a challenge is opened for the stakeholders including revenue

authorities to secure their respective interest in absence of appropriate governance. Due to this significant volume of international transactions, the multinational companies are in a position to transfer profits to low tax countries. The motives and modalities of inappropriate use of Transfer Pricing mechanism is discussed in various sections of chapter 1 and 2 of this paper. The requisite governance of these transactions is ensured by enacting the regulations and making the enterprise liable for fine and penalties for non-compliance.

Researcher's view on the efficacy of current system

There are certain concerns about the efficacy of the existing statutes to curb abuse of related party transactions which are aimed to benefit the majority shareholders. There are means by which the existing rules and regulations can be flouted. Some of the examples are discussed in length herein below:-

- a) If Company wants to enter into a related party transaction, the composition of Board is restructured to make the companies unrelated.
- b) The transactions are made so complex in nature and unravelling of the transactions become quite difficult to prove that these transactions falls under the purview of related party disclosures and compliances.

Concentrated ownership is normal in most countries around the world. Under such circumstances related party transactions are mainly within the company with controlling interest. An abusive related party transaction would be detrimental to the interest of minority shareholders and thus represents a breach of trust. Globally, potential to abuse related party transactions are perceived as critical policy issue. Although related party transactions are not fully restricted, regulators have sought to put in place approval processes to minimize the negative potential. Approval of related party transactions has been entrusted with Board of Directors. Enforcement is a key issue and

remains a challenge. The challenge is mainly to ensure independence of the Board. It is observed from reading of various legislations including Companies Act, 2013 that mainly few approaches have been taken to ensure good corporate governance in this regard. Firstly shareholders are entrusted with responsibilities to approve certain transactions and interested shareholders are excluded from approval process. Minority shareholders are provided an opportunity to select a board member or their choice. It is also observed that controlling shareholders has a fiduciary duty to other shareholders of the company.

It is important to understand that the role of independent directors is crucial for controlling direct and indirect related party transactions which are detrimental to the minority shareholders. However, the independent directors are appointed and removed currently by the majority shareholders through election. Therefore, an independent director is perceived to be acting as per will of the majority. Thus the efficacy of the independent director post needs to be scrutinized. To counter the misuse of majority power to reduce the efficacy of the post of independent directors, s.150¹⁵⁸ and s.151¹⁵⁹ of the Companies Act, 2013 was introduced. These sections are aimed to ensure independence of the independent directors.

Board should be comprises of sufficient number of independent non-executive directors capable of exercising independence about the tasks in case of potential conflict of interest. In order to fulfil the duty, the board members should have access to accurate, relevant and timely information in order to support their decision-making. Non-executive directors do not typically have the same access to the information as key managers within the

¹⁵⁸ Companies Act, 2013 §150 (deals with Manner and selection of independent directors and maintenance of databank of independent directors)

¹⁵⁹ Companies Act, 2013 §151 (deals with appointment of directors elected by small shareholders)

company. It is suggested by OECD in its guidelines, that the contributions of non-executive directors can be enhanced by providing access to certain key managers within the company such as, the company secretary and internal auditors.

The Satyam case underlined the flaws in the existing statutory framework to curb the abuse in related party transactions. The use of indirect means by corporates is real concern for curbing abusive related party transactions. Since abusive RPTs are undertaken between company groups which are controlled by majority shareholders in both the companies, shareholders' approval will not help to curb the abuse of related party transactions since the approval will be given by those majority shareholders only. Therefore, in such cases, approval by disinterested shareholders can be an option. However, classifying shareholders into interested and disinterested might pose a new challenge. The Companies Act 2013 emphasizes on the need to Audit committee approval for related party transactions. Also it has mandated the need of constitution of Audit committee with independent directors. The Act empowered the audit committee to classify various related party transactions into extraordinary and material, or non-extraordinary and non-material. The committee is further authorized to conduct investigation for any matter falling under its purview and obtain necessary professional help in this regard. These are inter-alia some of measures which could help to form an independent and professional board which is expected take an independent decision.

However, to achieve the objectives as stated in earlier paragraph, it is important to appoint independent (in strict sense) directors who will be capable to take uninfluenced decisions. However, currently the appointment and removal is done through election by a majority. Thus, positions of independent directors are controlled by majority. This in effect, limits the

efficiency of the independent directors and therefore the main purpose of appointing independent directors is not attained. Clause of new Companies Act, 2013, has addressed some of these issues like appointment of independent directors from databank maintained by institution, body or association or central government. Further s.151 of the Companies Act, 2013 provides that a listed company should have a director elected by small shareholders.

Thus, from the above analysis the researcher would like to conclude that enforcement of the Companies Act, 2013 to secure the interest of the minority shareholders should be entrusted with independent professional agencies, which inter alia should be allowed to audit the independence of the Board. The efficacy of the Secretarial Audits should be enhanced by issuing some auditing standards by the ICSI and MCA. The scrutiny of Secretarial Audits should be done by ROC in line with scrutiny of Income Tax Returns done by Income Tax Department. The researcher would like to submit that the exit route for the willing minority shareholders should be made much easier. The process of valuation of shares for buy-back or for mergers should take into consideration all future earning potentials to restrict "squeezing out" the minority shareholders by the majority shareholders. Also for all other transactions, where s.188 is not applicable¹⁶⁰, the respective provisions should be strengthened to secure the interest of all stakeholders. Finally, the researcher would like to recommend that government should ensure a proper coordination mechanism between all respective regulators for a coordinated effort to unravel the complex nature of related party transactions to secure the interest of all stakeholders

¹⁶⁰ Income Tax Act, 1961, § 92 (Like international transactions or specified domestic transactions)

