Article

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Deciphering 'Associate Company'

under Companies Act, 2013

For the first time in the Indian Company Law, there is a reference of 'Associate Company' in relation to another company and there are applicable provisions for necessary compliances in the Companies Act, 2013("Act"). The reference of 'associate company' in the Act, is in the definition of Related Party (sub-section (76) of Section 2), Financial Statements (Section 129), eligibility, qualifications and disqualifications of auditors (Section 141), Statutory Auditor not to render certain services (Section 144), Appointment of independent directors (Section 149), Related Party Transactions (Section 188), Restriction on non-cash transactions involving directors (Section 192), Merger or amalgamation of certain companies (Section 233), etc.

Discussion:

'Associate Company' has been defined in sub-section (6) of Section 2 of the Companies Act, 2013 as in relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company. The explanation to sub-section (6) of Section 2 of the Act elaborates 'significant influence' as it means control of at least 20% of total share capital, or of business decisions under an agreement.

The essence of determining whether a company is an associate company of another company is to determine whether there is a 'significant influence' by such other company. However, it is important to note that the 'associate company' is not a 'subsidiary company', though it includes joint-venture company. For determining 'significant influence', any one of the following conditions needs to be complied with:

(i) Control of at least 20% of total share capital by another company,
(ii) Control of business decisions under an agreement.

With respect to (i), the total share capital means equity share capital and convertible preference share capital. It is however necessary that non- convertible preference share capital is excluded as contemplated by clause (r) of Rule 2 of Companies (Specification of definitions details) Rules, 2014. Sub-section (27) of Section 2 of Companies Act, 2013 defines 'control'. It includes right to appoint majority of the directors or right to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner. Therefore, broadly, one can say that a company in which the other company holds more than 20% but less than 50% of the total share capital, can be termed as 'associate company'.

With respect to (ii) i.e. "control of business decisions under an agreement", this phrase has created enormous conundrum amongst corporates and practicing professionals. It is essential to note here, that if this condition is satisfied then a company will be an 'associate company', even if there is no control of even 20% of total share capital. The clause is applicable even when the control of business decision is under an oral agreement or a written agreement. With respect to considering the applicability of clause (ii), the essence is in understanding the meaning of "control of business decisions".

A practical example will help us to understand the applicability of the clause. Suppose, A Ltd. is having a business agreement which relates to the manufacturing of products for a leading automobile company i.e. B Ltd. The former company 's 100% turnover arises from this activity only. There are no common directors / shareholders between A Ltd and B Ltd. B Ltd is not holding any shares of A Ltd, however, A Ltd. is bound by the agreement and there is no other relation between the companies. Whether this agreement will make A Ltd an Associate Company of B Ltd.? In my view, such agreement will not fall under clause (ii) for determining the relationship of 'associate company', because there is no control over the business decisions under the agreement. Also, to control the business decisions, it is necessary that the business decisions are taken by board of directors or one level below the board.

Accounting perspective of 'significant influence':

For the purpose of understanding 'significant influence', we can refer the definitions in Accounting Standards. Accounting Standard – 18 (relating to 'related party disclosures') defines 'significant influence' as participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies. The Indian Accounting Standard – 24 (relating to 'related party disclosures') defines 'significant influence' as the power to participate in the financial and operating policy decisions of an entity, but has no control over those policies. Significant influence may be gained by share ownership, statute or agreement. It can be said that the Indian Accounting Standard – 24 is an extension of Accounting Standard– 18, wherein the mode of obtaining 'significant influence' is defined.

Conclusion:

It is extremely essential to comprehend and apply the meaning of 'associate company' as the definition has a very wider impact on the compliance of key provisions of Companies Act, 2013 which includes, determination of related party, preparation of the financial statements, eligibility, qualifications and disqualifications of auditors, appointment of independent directors, Related Party Transactions and restriction on non-cash transactions involving directors.

Tax Info

Exemption in Long Term Capital Gain arising on Transfer of Residential House

Section 54 of the Income Tax Act, 1961 provides the exemption to assessee in respect of long term capital gain arising from the transfer of a residential house. It lays down certain conditions to enjoy the exemption;

1. The capital gain should arise from the transfer of long term capital asset being buildings or lands appurtenant thereto, being a residential house.
2. The income from such residential house shall be assessable under the head of 'Income from house property'.
3. The transferor shall be an individual or Hindu Undivided Family.
4. The transferor assessee should have purchased a residential house within a period of one year before or two years after the date of transfer; or, in the alternative, the assessee should construct the residential house within a period of three years from the date of the transfer of the original house.
5. The amount invested in the purchase or construction of the new residential house should either be equal to or more than the gain, or where it is less than the amount of capital gain, the shortfall shall be taxable under section 45 (1) of the Act.

Trivia: Paying advance to the extend/more than of capital gain for purchase of new flat is good compliance of Section 54/54F (Hasmukh N. Gala v. ITO ITA No. 7512/MUM/2012 dt. 19.08.2015 (Mumbai Tribunal)).