

PURPOSE AND EFFECT TEST FOR RPTs

March 17, 2023

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 - Based out of Kolkata, Mumbai, New Delhi and Bengaluru
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Focus on capabilities; opportunities follow

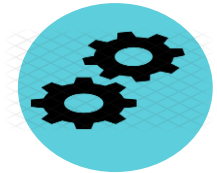
Outline

- Brief introduction to RPT framework for listed entities
- Why do RPTs exist?
 - Abusive and non-abusive RPTs
- Global perspective of approval & disclosure requirements of RPTs
- Broad overview of RPT controls in case of listed entities
 - Definition of Related Party
 - Meaning of “Transaction” and the purpose and effect test
 - Amended definition of RPTs
 - Approvals required for RPTs post amendments
- Shareholders’ approval
 - Approval from shareholders and exemptions
 - Contracts vs transactions and ongoing transactions
 - Process of approval for RPT
- The Purpose and Effect test
 - Amended scope of the definition of RPT, effective 1st April, 2023
 - Decoding the phrase “Purpose and Effect” (P&E)
- Undisclosed RPTs - guidance from other standards and jurisdictions
 - Purpose and effect test in global jurisdictions
 - Definition of RPT in other jurisdictions
 - Undisclosed RPTs - some global precedents
 - Undisclosed RPTs - audit standards
 - Indicators of undisclosed related party transactions - PCAOB
 - Arrangements having potential of undisclosed RPTs - ISA 550
 - Terminology used in GAAR
- Meaning of related parties - guidance from other laws and regulations in India
 - “Associated enterprises” from transfer pricing perspective
 - “Related Person” from GST perspective
 - “Related Parties” under IBC
- Practical guide to RPTs qualifying P&E test
 - Role of audit committee
 - Consequences of detecting undisclosed RPTs

Chronology of events for purpose and effect test

Chronology of events

Jan 27, 2020



Report of the Working Group on Related Party Transactions

Sept 28, 2021



Approval for amendments in RPT framework in SEBI Board Meeting based on Report of the Working Group

Nov 09, 2021



Amendment in RPT framework notified vide SEBI (LODR) (6th Amendment) Regulations, 2021

April 01, 2023



Purpose and effect test for RPT

History and Background

- The intent of the insertion was obviously based on observation/experience
- The Working Group observed that
 - *“Shell or apparently unrelated companies, controlled directly or indirectly, by such persons were purportedly used to siphon off large sums of money through the use of certain innovative structures, thereby circumventing the regulatory framework of RPT.”*
 - *“certain innovative structures have been used to avoid classification of transactions as RPTs and thus avoid the associated regulatory compliance and disclosure requirements. Some such instances are mentioned below:*
 - *use of complex structures;*
 - *transactions undertaken by a listed entity with seemingly unrelated parties, however intended to benefit related parties; and*
 - *instances of loans being given to an unrelated party which in turn gives such loan to a related party.”*

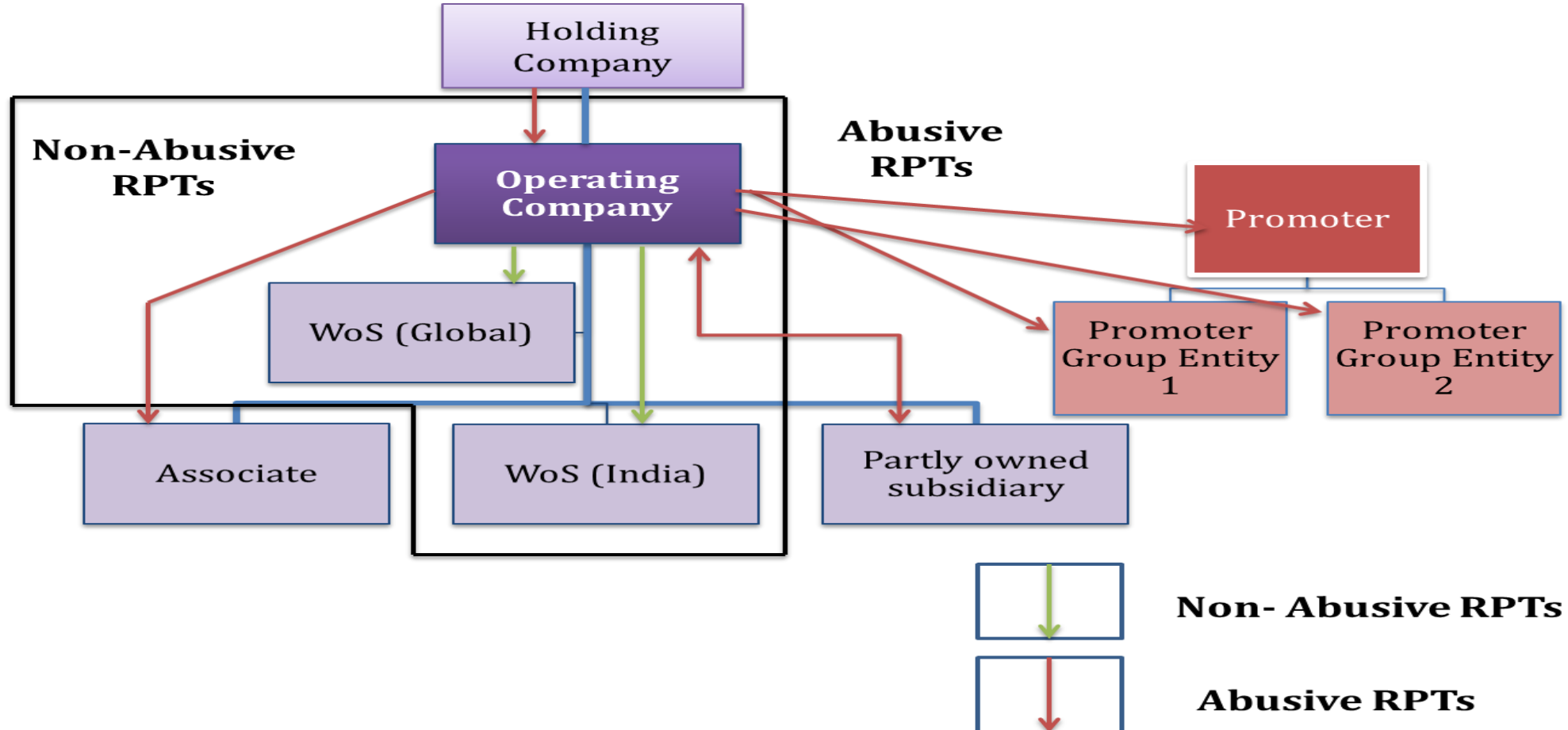
Why do RPTs exist?

- To an extent, RPTs are a part of the corporate structure itself:
 - For example, marketing entities, servicing entities, brand-owning companies, etc.
- RPTs are not necessarily abusive:
 - Generally speaking, transactions with WOSs are non abusive
 - However, transactions with partly owned entities, associates, promoter and promoter group entities may be designed to adversely affect the interest of stakeholders
- RPTs may also exist to create non-existent turnover, non-existent revenues, or circular network or shareholdings

Major types of abusive RPTs

- Tunnelling transactions
- Propping transactions
- Self dealing

Abusive and Non-Abusive RPTs



Global perspective of approval & disclosure requirements of RPTs (1/4)

Jurisdiction	Disclosure		Approval procedure			Shareholder approval (non-equity)
	Periodic disclosure	Ongoing disclosure (Immediate for specific RPTs)	Board approval			
			Non-routine RPTs	Review by INEDs/audit committee	Opinion from outside specialist	
Argentina	Local standard	Required	Required	Optional	Optional	Required
Australia	Local standard		Required			Required
Austria	IAS 24		Required			
Belgium	IAS 24	Required	Required	Required	Required	
Brazil	IAS 24	Required			Recommended	
Chile	IAS 24		Required	Required	Recommended	Required
Colombia	IAS 24	Required	Required	Recommended		Required
Czech Rep.	IAS 24					
Denmark	IAS 24					
Egypt						

Global perspective of approval & disclosure requirements of RPTs (2/4)

Jurisdiction	Disclosure		Approval procedure			Shareholder approval (non-equity)
	Periodic disclosure	Ongoing disclosure (Immediate for specific RPTs)	Board approval			
			Non-routine RPTs	Review by INEDs/audit committee	Opinion from outside specialist	
Finland	IAS 24					
France	IAS 24		Required		Required	
Germany	IAS 24					
Hong Kong (China)	IAS 24 or local standard	Required	Required	Required		Required
Hungary	IAS 24		Required			Required
Ireland	IAS 24		Required		Required	Required
Israel	IAS 24	Required for SHs approval	Required	Required		Required
Italy	IAS 24	Required	Required	Required	Required if requested by INEDs	Required
Japan	Local standard	Required	Required	Recommended		

Global perspective of approval & disclosure requirements of RPTs (3/4)

Jurisdiction	Disclosure		Approval procedure			Shareholder approval (non-equity)
	Periodic disclosure	Ongoing disclosure (Immediate for specific RPTs)	Board approval			
			Non-routine RPTs	Review by INEDs/audit committee	Opinion from outside specialist	
Korea	IAS 24	Required	Required			
Latvia	IAS 24 and local standard		Required			
Lithuania						
Malaysia						
Mexico	IAS 24	Required	Required	Required	Required	Required
Netherlands	IAS 24					
Norway	IAS 24		Required			Required
Poland	IAS 24					
Portugal	IAS 24					Required
Russia	IAS 24 or local standard	Required		Recommended	Recommended	Required

Global perspective of approval & disclosure requirements of RPTs (4/4)

Jurisdiction	Disclosure		Approval procedure			Shareholder approval (non-equity)
	Periodic disclosure	Ongoing disclosure (Immediate for specific RPTs)	Board approval			
			Non-routine RPTs	Review by INEDs/audit committee	Opinion from outside specialist	
Saudi Arabia	IAS 24	Required	Required		Required	Required
Singapore	IAS 24, US GAAP or local standard	Required	Required	Required	Required	Required
Slovenia	IAS 24			Required		
South Africa	IAS 24	Required	Required	Required	Optional	Required
Spain	IAS 24		Required	Required		Required
Sweden	IAS 24	Required				Required
Switzerland	IAS 24 or US GAAP, Swiss GAAP FER or local standard	Required			Recommended	
Turkey	IAS 24	Required	Required	Required	Required	Required
United Kingdom	IAS 24	Required				Required
United States	US GAAP, Item 404 of Regulation S-K, ASC 850 and Rule 4-08(k) of Regulation S-X		Required	Recommended	Recommended	Required



Broad overview of RPT controls in case of listed entities



Definition of Related Party

1. Under Companies Act, 2013 (CA)

- Director or KMP or his relative
- Firm, in which a director, manager or his relative is a partner;
- Private company in which a director or manager or his relative is a member or director;
- Public company in which a director or manager is a director and holds along with his relatives, >2% of its paid-up share capital;
- Any body corporate whose BOD, MD or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager;
 - NA if advice given in professional capacity
- Any person on whose advice, directions or instructions a director or manager is accustomed to act.
 - NA if advice given in professional capacity
- Any body corporate which is;
 - a holding, subsidiary or an associate company of such company;
 - a subsidiary of a holding company to which it is also a subsidiary; or
 - an investing company or the venturer of the company

2. Under LODR Regulations

- Related Party” means:
 - as defined under section 2(76) of CA
 - Applicable Accounting Standard (AS)
- Deemed RP
 - Any person/ entity belonging to promoter/ promoter group
 - irrespective of their shareholding
 - Any person/ entity
 - holding equity shareholding
 - 20% or more [w.e.f April 1, 2022]
 - 10% or more [w.e.f April 1, 2023]
 - Either directly, OR
 - Beneficial interest basis as under section 89 of CA, 2013
 - At any time during the immediate preceding FY

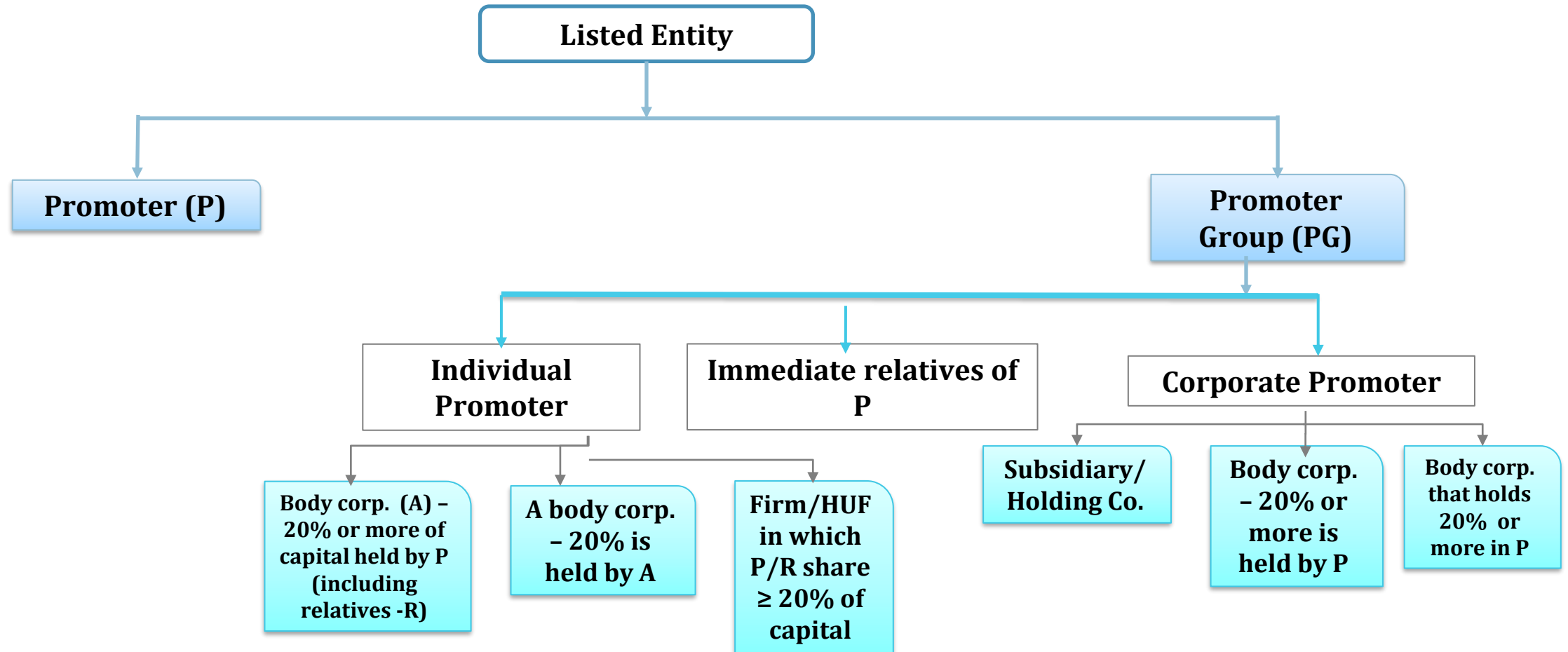
Difference between Act and LODR w.r.t. RPs and RPTs

- All equity listed entities
 - Including entities which are not companies, say, banks
- In case of Debt listed entities
 - HVDLEs - applicable by virtue of Reg 15 (1A)
 - On COREX basis up to FY 22-23
 - Mandatory thereafter
 - Non HVDLEs - not applicable

Major differences between Reg 23 and sec. 177/188

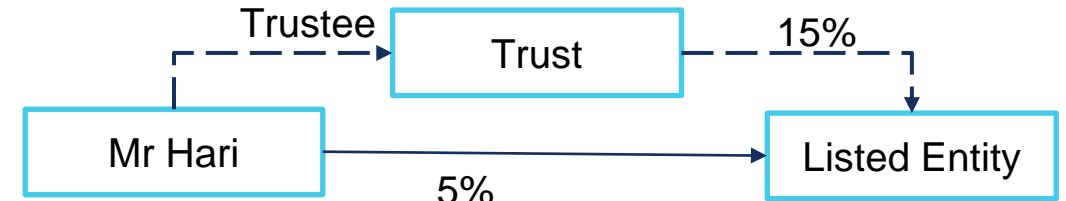
Basis of Difference	Sec 177/188	Reg 23
Applicability	All companies (audit committee requirement only for certain companies)	Equity Listed entities, HVDLEs
Definition of RPs	Comes from sec. 2 (76)	Combo of sec. 2 (76), AS/IndAS and other limbs
Definition of RPT	Not defined	Defined in lines with AS/IndAS and other limbs
Specifications of transactions	Transactions listed in sec. 188	No such specification
Materiality thresholds	Based on 10% of turnover or networth/ 1% of networth/ rem. limit of 2.5 Lakhs/mth	Lower of 10% of consolidated turnover, or Rs 1000 crores. Brand Usage - 5% of consol turnover
OC & AL exception	Applies under sec. 188	Does not apply
Group approach by looking at subsidiary cos.	Does not apply	Applies
Prior approval from shareholders	Not required	Required

Definition of Related Party - Meaning of promoter and promoter group

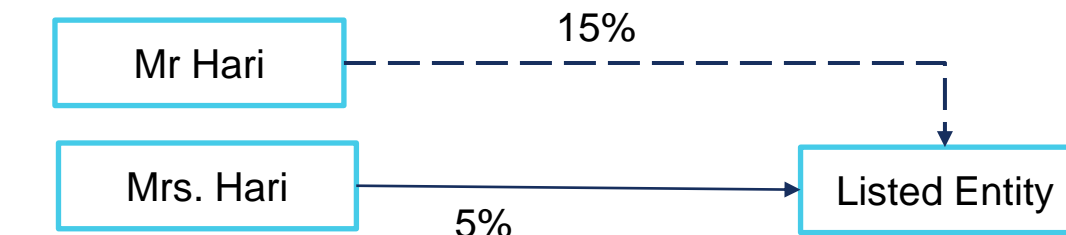
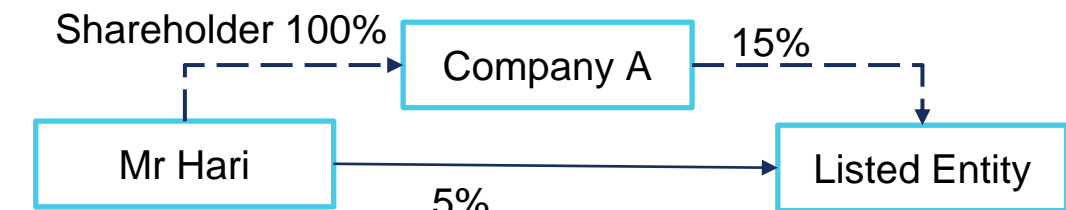
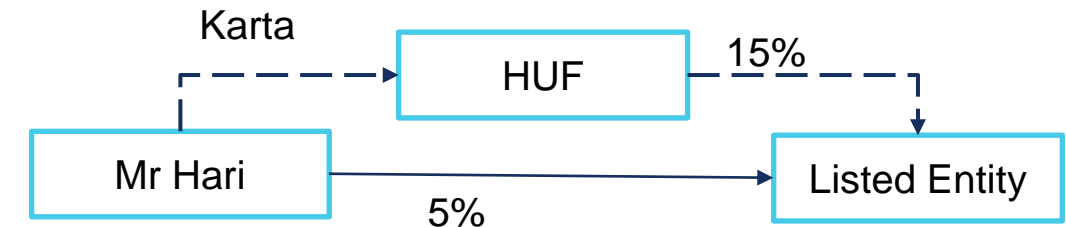


Definition of Related Party – Meaning of Beneficial interest

- **Beneficial interest basis** [as defined u/s 89 of CA, for the purpose of section 89 and 90], includes:
 - directly or indirectly, through any contract, arrangement or otherwise,
 - the right or entitlement of a person alone or together with any other person to-
 - exercise or cause to be exercised any or all of the rights attached to such share; or
 - receive or participate in any dividend or other distribution in respect of such share.
- **Does the definition also capture indirect interest or control by subsidiary entities?**
 - In essence, we are simply taking:
 - Shareholders as per register of members
 - Declared beneficial owners as per Section 89 of CA 13



What if Mr Hari was acting as a beneficiary of the Trust?



Definition of related party under Ind AS 24

3. Under Ind AS-24

- Person [Para 9(a)]
 - A person or a close family member is related if he:
 - Has control/joint control [Para 9(a)(i)]
 - Has significant influence [Para 9(a)(ii)]
 - Is a member of the key managerial personnel (KMP) [Para 9(a)(iii)];
 - of the reporting entity or its parent.
 - Close members of a family of a person [Para 9(a)]
 - are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including:
 - That person's children, spouse or domestic partner, brother, sister, father and mother [Clause (a) of the definition];
 - Children of that person's spouse or domestic partner [Clause (b) of the definition]; and
 - Dependants of that person or that person's spouse or domestic partner [Clause (c) of the definition];
- KMPs are those person having authority and responsibility for
 - planning,
 - directing and
 - controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity [Definition under Para 9]

Definition of Related Party – basis of calculating threshold

“At any time, during the immediate preceding financial year”

Situations for evaluation

Preceding Year	Current Year
Holding > threshold	Continues to exceed
Holding > threshold	NIL holding
Holding < threshold	Holding > threshold
Variation in the shareholding during the FY	NIL holding
April 1 - Holding > threshold	
June 30 - Holding < threshold	
Dec 30 - Nil holding	

Questions

- Can institutional investors also become related parties?
- Do we also go beyond the list of members?
- Do we aggregate the holding of the person in different capacities?
 - Or the holdings are based on PANs
 - Or holdings of husband /wife
- Can the holders of GDRs be included in the list of RPs?
- Definition of related party of a subsidiary?
 - Listed subsidiary
 - Unlisted company
 - Foreign subsidiary

“Persons” and “Entities” as per IND AS 24

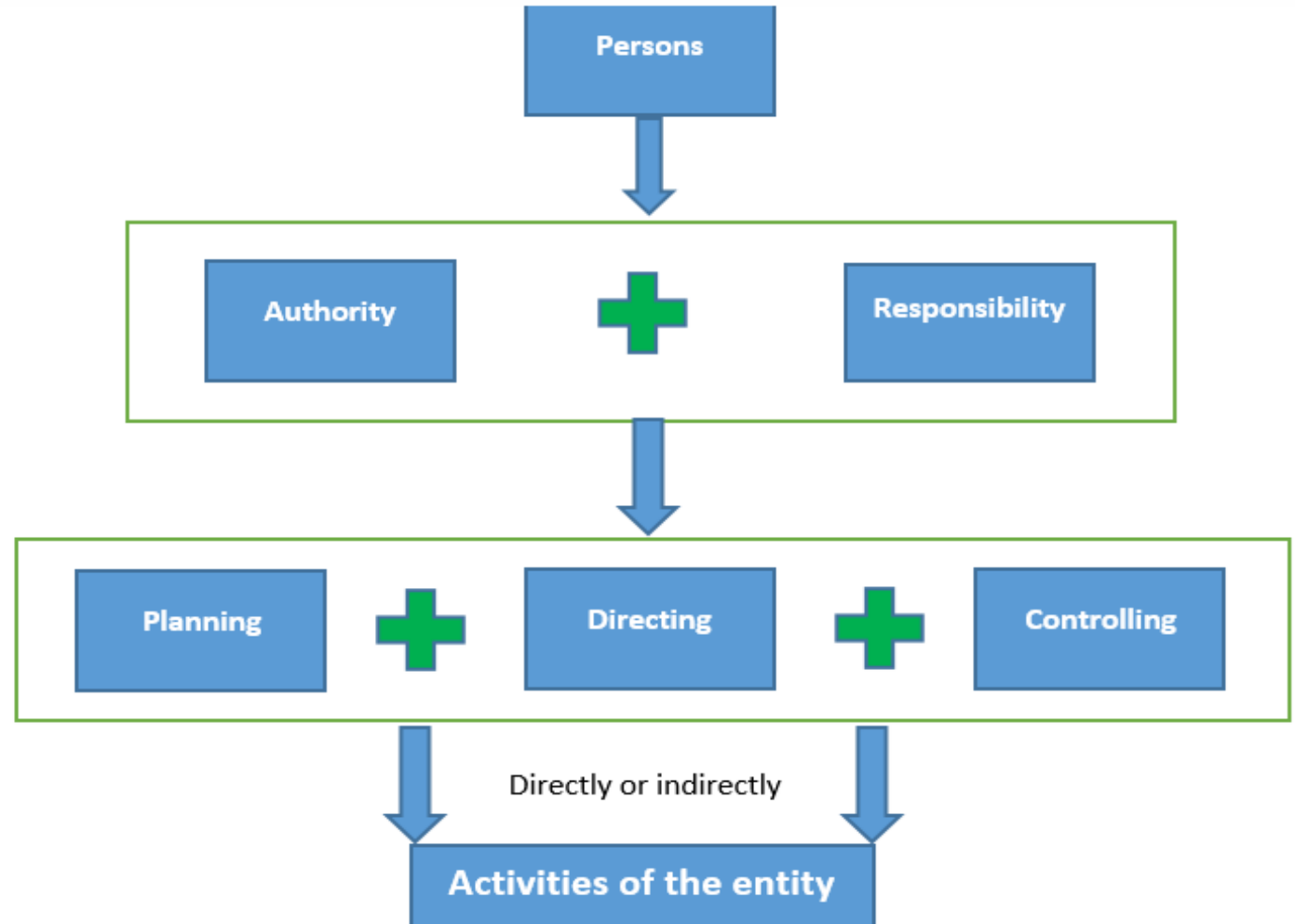
- IND AS 24 uses two expressions
 - Persons – unlike the legal meaning of the term, accounting standards use the word in the sense of “individuals”
 - Entities – that is, any entity, whether incorporated or not
- Hence, the limbs for determination of “related party” are different in case of persons and entities
- “Persons” applies for determining, with reference to the entity in question, whether a person is a related party or not
- “Entities” applies, with reference to the entity in question, whether the entity is a related party or not

Close members of family of the 'Person'- Para 9(a) of IND AS 24

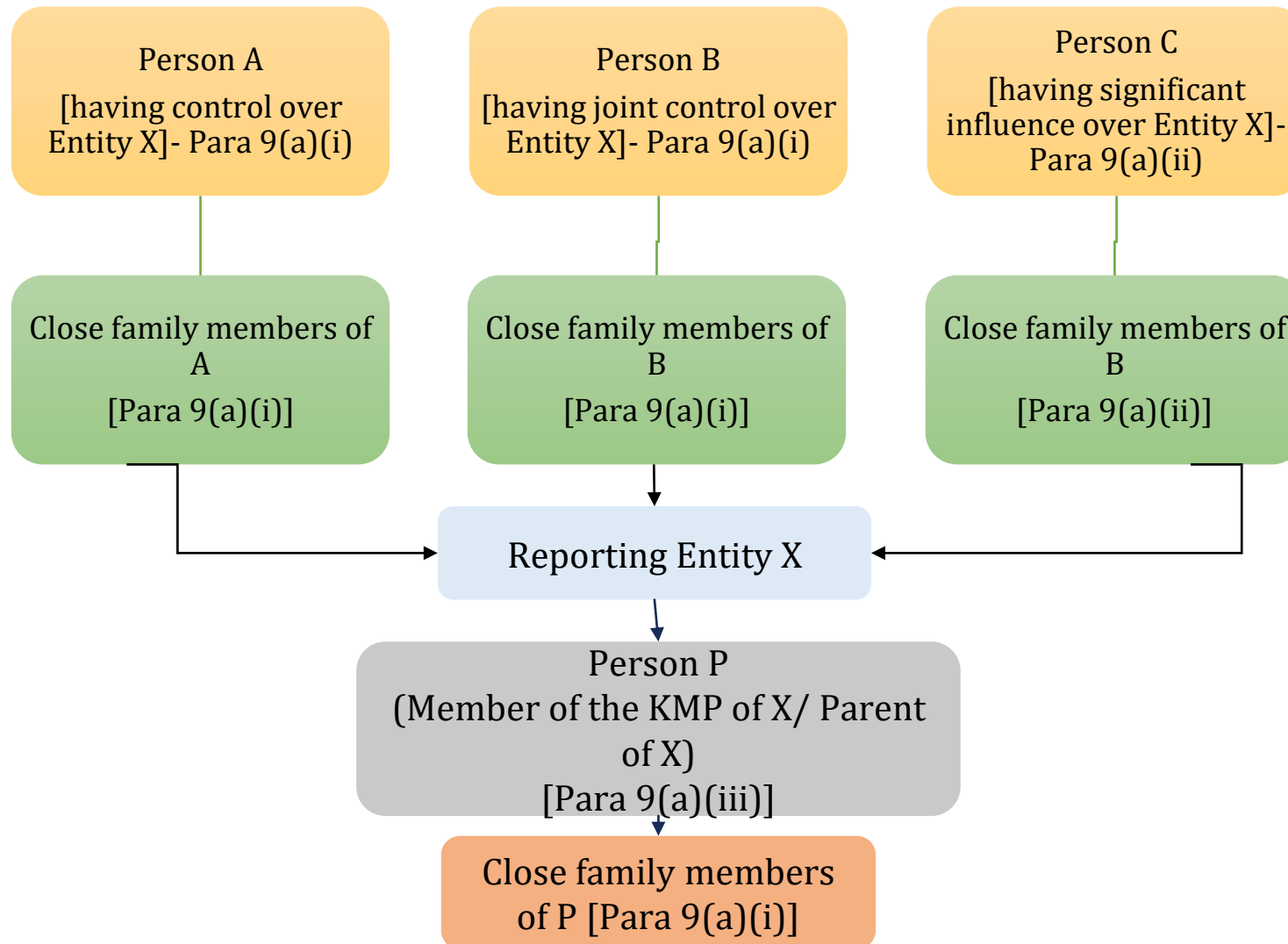
- Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including:
 - Father/ mother
 - Brother/sister
 - Spouse/domestic partner
 - Children
 - Children of spouse/domestic partner
 - Dependents of the person, spouse/domestic partner

KMPs under IND AS 24

- For practical purposes, the term KMP in AS 24 means the governing body, such as the board of directors, board of governors, etc



Person who are related parties u/ Para 9(a) of IND AS 24

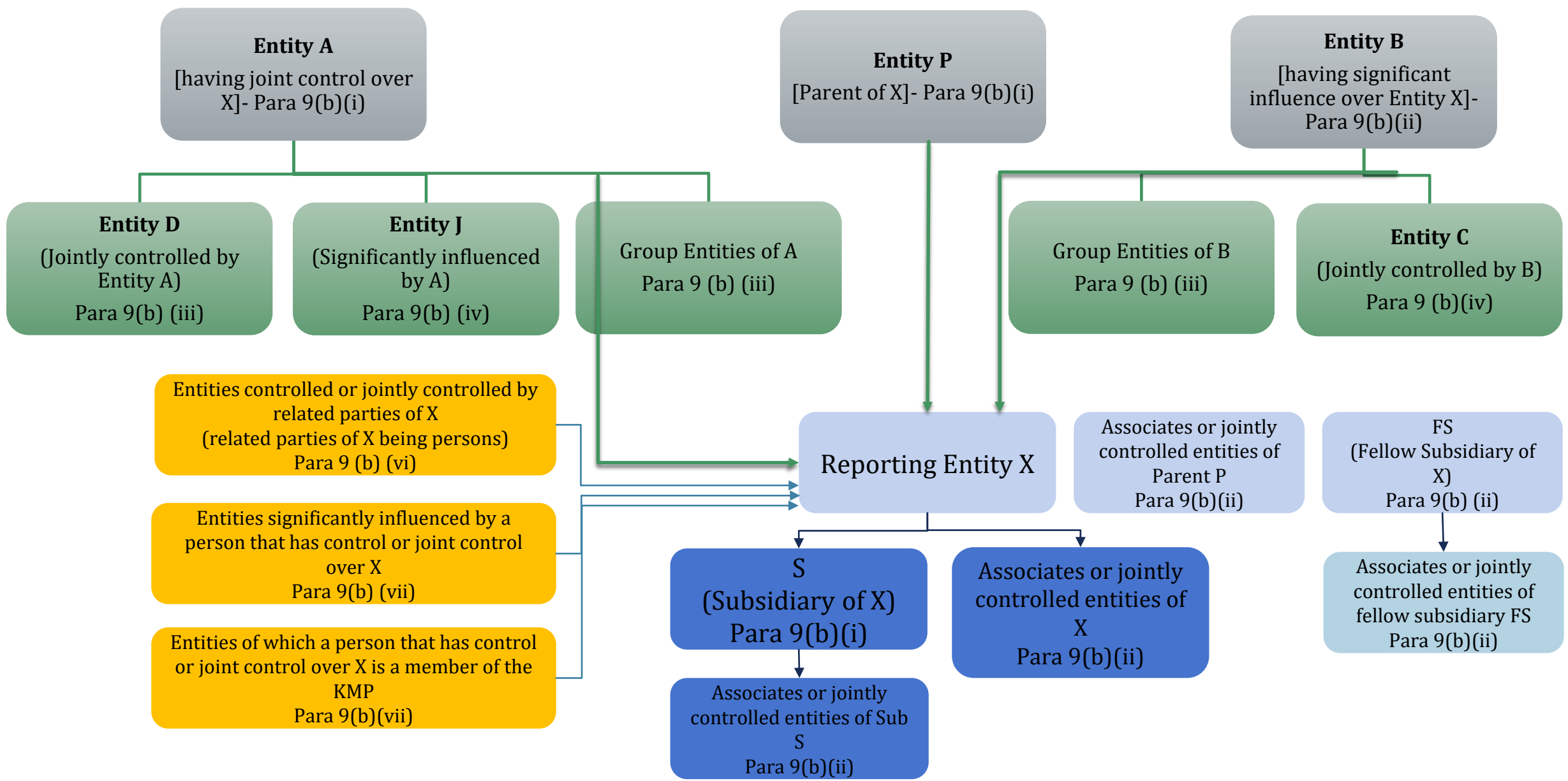


Entities which are related parties under Ind AS 24

■ Entity [Para 9(b)]

■ An entity is related to a reporting entity if any of the below conditions are met:

- Parent, subsidiaries and fellow subsidiaries [Para 9(b)(i)]
- One entity is JV or an associate of the other entity [Para 9(b)(ii)];
- One entity is associate/ JV of a member of the same group of the other entity [Para 9(b)(ii)];
- Both entities are JV of the same third party [Para 9(b)(iii)]
- One entity is a JV of a third party and the other entity is an associate of the third entity [Para 9(b)(iv)];
- The entity is a post-employment benefit plan for the employees [Para 9(b)(v)]
 - of the reporting entity or
 - of an entity related thereto
- The entity is controlled or jointly controlled by the natural person who is a related party [Para 9(b)(vi)];
- A person having control or joint control of the reporting entity has significant influence over the entity or is the member of the KMP of the entity or of the parent [Para 9(b)(vii)];
- The entity or any member of its group providing KMP services to the reporting entity or to the parent of the reporting entity [Para 9(b)(viii)]



Entity A
[having joint control over X]- Para 9(b)(i)

Entity P
[Parent of X]- Para 9(b)(i)

Entity B
[having significant influence over Entity X]- Para 9(b)(ii)

Entity D
(Jointly controlled by Entity A)
Para 9(b) (iii)

Entity J
(Significantly influenced by A)
Para 9(b) (iv)

Group Entities of A
Para 9 (b) (iii)

Group Entities of B
Para 9 (b) (iii)

Entity C
(Jointly controlled by B)
Para 9 (b)(iv)

Entities controlled or jointly controlled by related parties of X
(related parties of X being persons)
Para 9 (b) (vi)

Entities significantly influenced by a person that has control or joint control over X
Para 9(b) (vii)

Entities of which a person that has control or joint control over X is a member of the KMP
Para 9(b)(vii)

Reporting Entity X

Associates or jointly controlled entities of Parent P
Para 9(b)(ii)

FS
(Fellow Subsidiary of X)
Para 9(b) (ii)

S
(Subsidiary of X)
Para 9(b)(i)

Associates or jointly controlled entities of X
Para 9(b)(ii)

Associates or jointly controlled entities of fellow subsidiary FS
Para 9(b)(ii)

Associates or jointly controlled entities of Sub S
Para 9(b)(ii)

Definition of Related Party under AS-18

4. Under AS-18

- Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise including holding companies, subsidiaries and fellow subsidiaries;
- Associates and joint ventures;
- Company to which the reporting enterprise is an associate or a joint venture;
- 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;
- KMP and relatives of such personnel; and
- Enterprises over which any person described in (c) or (d) (*immediately preceding two bullets above*) is able to exercise significant influence - 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.

Meaning of “Transaction” and the purpose and effect test

Amended Provisions

“Related Party Transactions” means:

- A transaction involving
- transfer of resources, services or obligations between
 - a listed entity or any of its subsidiaries on one hand and a related party of the listed entity or any of its subsidiaries on the other hand; or
 - a listed entity or any of its subsidiaries on one hand, and any other person or entity on the other hand,
 - the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries, [w.e.f. April 1, 2023]
- regardless of whether a price is charged; and
- a “transaction” with a related party shall be construed to include a single transaction or a group of transactions in a contract

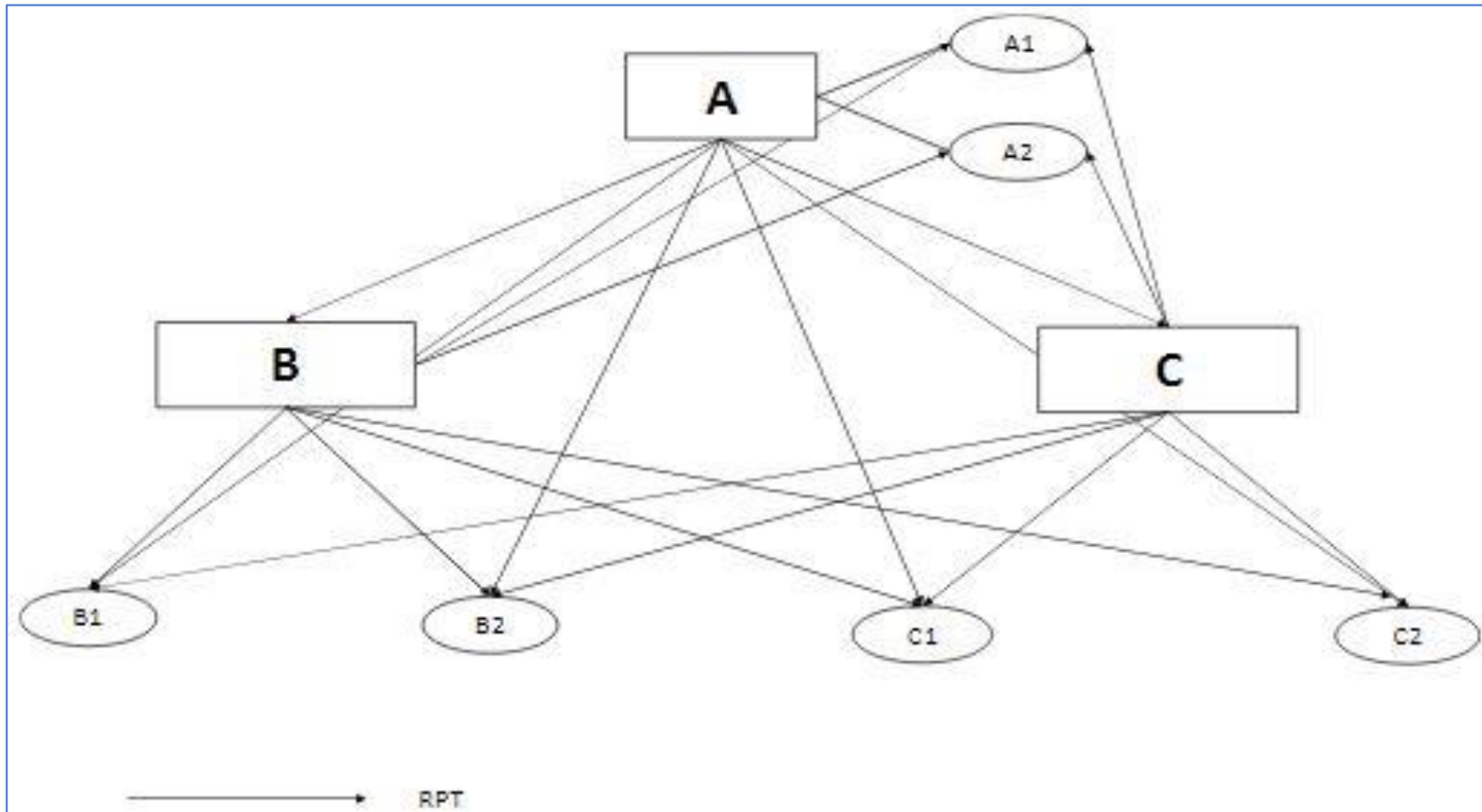
Erstwhile provisions

“Related Party Transactions” means:

- a transfer of resources, services or obligations
 - between a listed entity and a related party
 - regardless of whether a price is charged and
 - a "transaction" with a related party shall be construed to include a single transaction or a group of transactions in a contract

Under the Companies Act, 2013, no definition of related party transaction is provided. Section 188 provides for certain types of transactions for which approval shall be required.

Amended definition of RPTs



A is a listed entity; B and C are its subsidiaries. A1/A2, B1/B2 and C1/C2 are related parties of A, B and C respectively.

Representation excludes second part of the recommendations which refer to transactions with unrelated parties, the **purpose and effect** of which is, to benefit related parties of the listed entity.

Source: [Annexure II of SEBI Meeting file](#)

Approvals required for RPTs post amendments (1/2)

Party to RPT	Transacting party	Approval of Audit Committee	Approval of Shareholders *
Holding company	RP of holding company	Yes	Required if material - 10% of consolidate turnover or Rs. 1000 crores - lower
Holding company	RP of subsidiary	Yes	-Do-
Subsidiary	RP of subsidiary	required if material - 10% of consolidated turnover <u>10% of subsidiary's standalone turnover (w.e.f 1st April, 2023)</u>	-Do-
Subsidiary	RP of holding company	- Do-	-Do-
Subsidiary	RP of fellow subsidiary	-Do-	-Do-

*** No RPs shall vote to approve**

Approvals required for RPTs post amendments (2/2)

Party to RPT	Transacting party	Approval of Audit Committee	Approval of Shareholders *
Listed subsidiary - equity listed	RP of holding company/subsidiary/fellow subsidiary	not required at holding company's level	not required at holding company's level
Listed subsidiary - debt listed	RP of holding company/subsidiary/fellow subsidiary	same as that of an unlisted subsidiary	same as that of an unlisted subsidiary
Listed subsidiary - HVDLE	RP of holding company/subsidiary/fellow subsidiary	not required at holding company's level, if the HVDLE complies	not required at holding company's level, if the HVDLE complies

All the aforesaid cases refer to such transactions where the listed holding entity is not a party

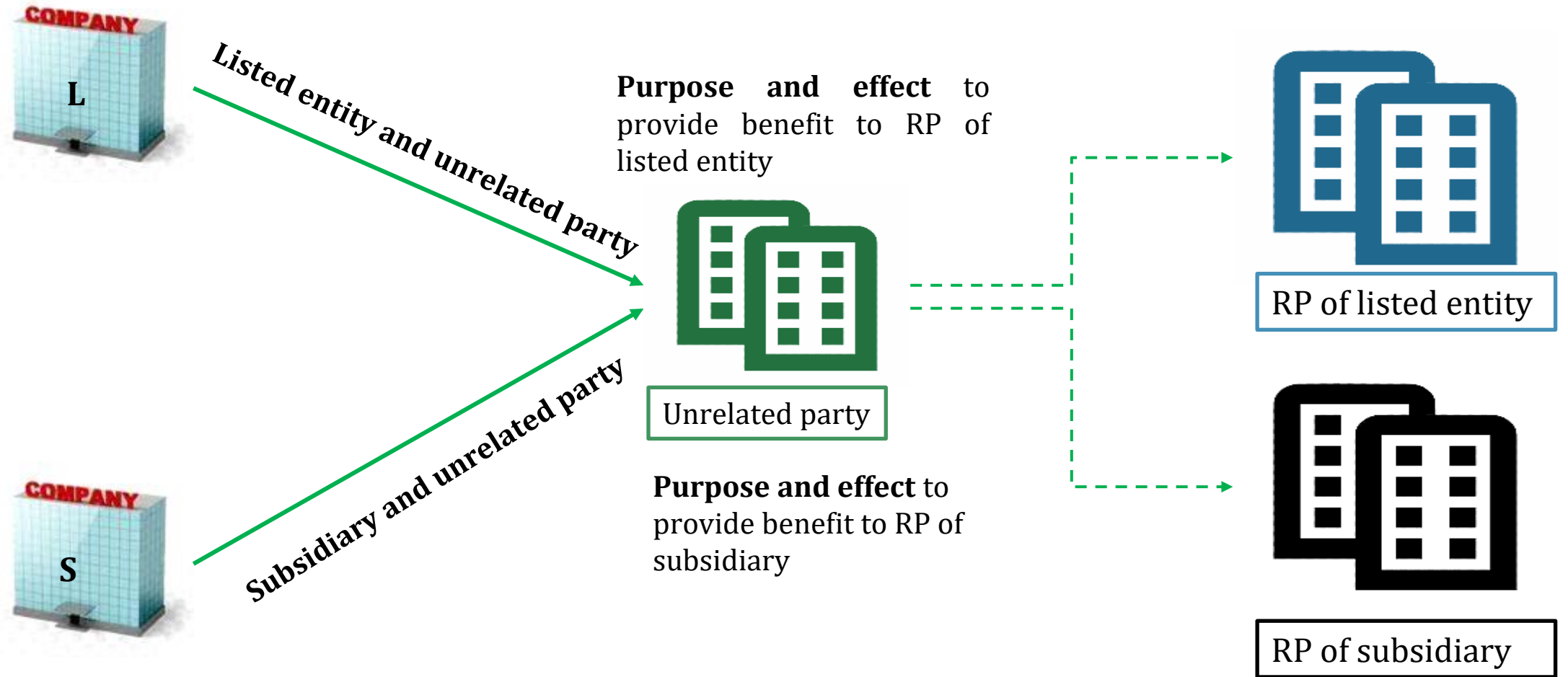
*** No RPs shall vote to approve**



The purpose and effect test



Amended definition of RPTs wef 1st April, 2023



Decoding the phrase “Purpose and Effect” (P&E)

Purpose

- never documented or explicit
- may be evident by examining the commercial justification of a transaction
 - If the transaction did not have a commercial justification, sans the benefit to the RP, the purpose becomes clear
- determination remains subjective and investigative/forensic.

Effect

- is likely to be explicit.
- may be evident by examining the presence of purpose
 - If the transaction did not have a purpose to benefit, however, effect is visible, the same may not be counted
- determination remains subject to establishment of purpose.

The words have been used cumulatively, with a conjunctive, hence both the purpose and effect have to be directed to the RP.

Purpose	Effect
✓	✓
✓	✗
✗	✓
✗	✗

Meaning of the expression “purpose and effect”

- **The expression used is “purpose and effect”. Expressions similar to this have been used in different contexts in the past.**
- **The obvious intent is anti-avoidance**
- **Therefore, the idea to capture transactions where the identity of the related party was concealed/camouflaged**

Some essential conditions for the Purpose and effect test	
The transaction is not a transaction in ordinary course of business; it is inspired by the sole or dominant motive of benefiting a related party	While the terms are two, the “purpose” test seems more important. Mere effect of benefiting a related party doesn’t invite the P&E test
One or more layers of unrelated parties have been interposed in the transaction but the chain between the listed entity, and the related party as the eventual beneficiary, is clear and visible	If the purpose and effect are both clear and present, the fact that the transaction benefits the listed entity as well doesn’t matter. RPTs are RPTs, no matter that they benefit the entity as well
The effect of benefiting the RP is clear and direct - it is not a collateral benefit, indirect benefit, oblique benefit, or that RP is one of the beneficiaries	If the transaction is motivated with the intent of benefiting an RP, the fact that the transaction passes through several stop-overs, or there is a value addition by intermediaries, or change of form of transaction, or time gap, should not matter

Decoding P&E | Illustration 1 and 2

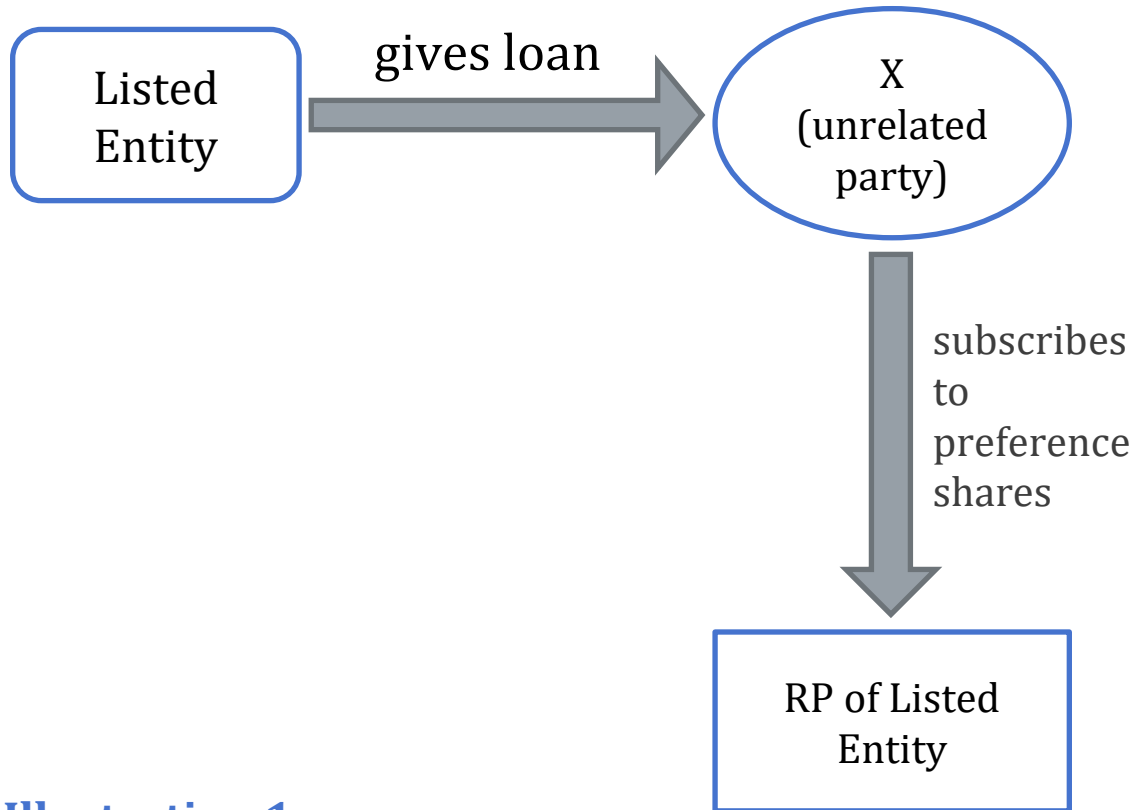


Illustration 1

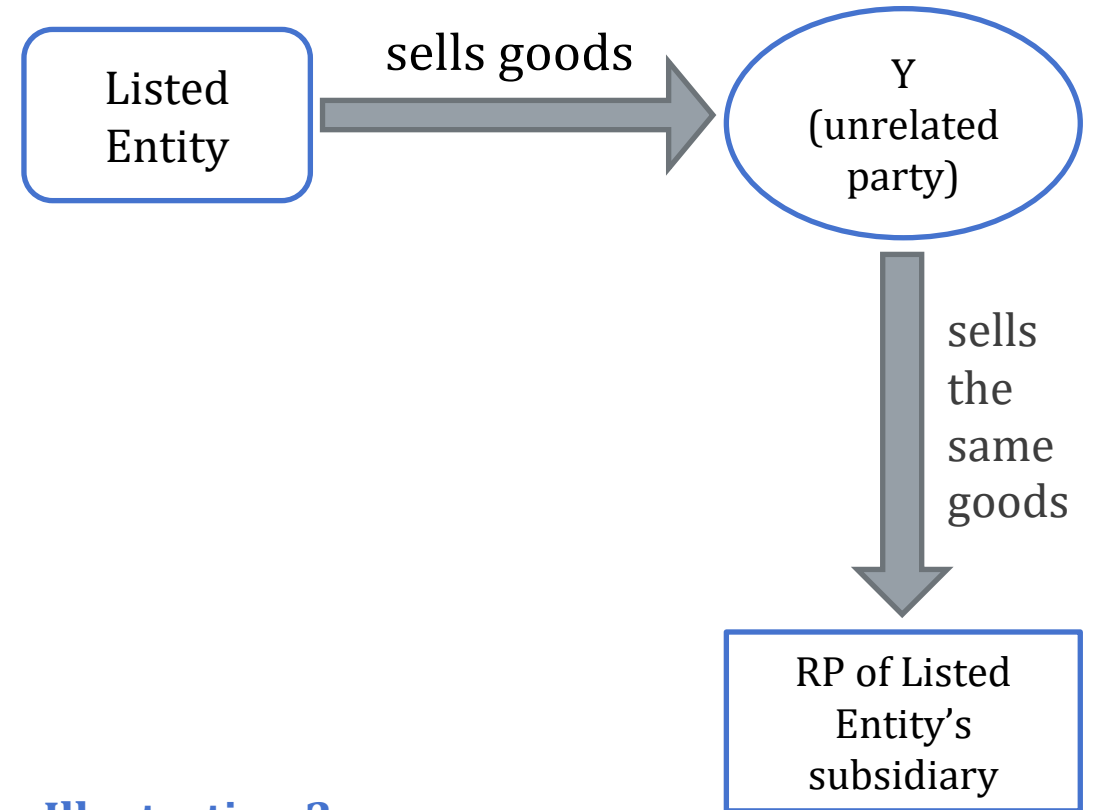


Illustration 2

What if Y is a wholly-owned subsidiary of Listed Entity?

Decoding P&E | Illustration 3 and 4

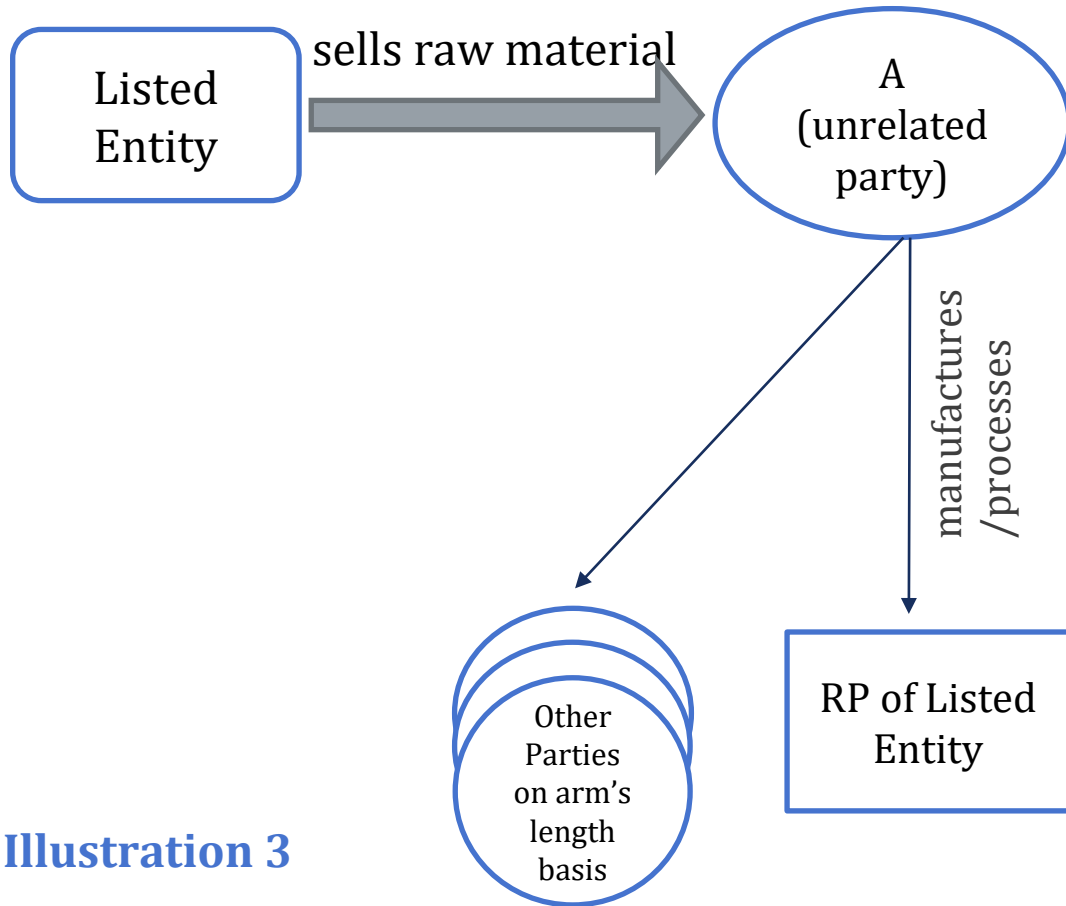


Illustration 3

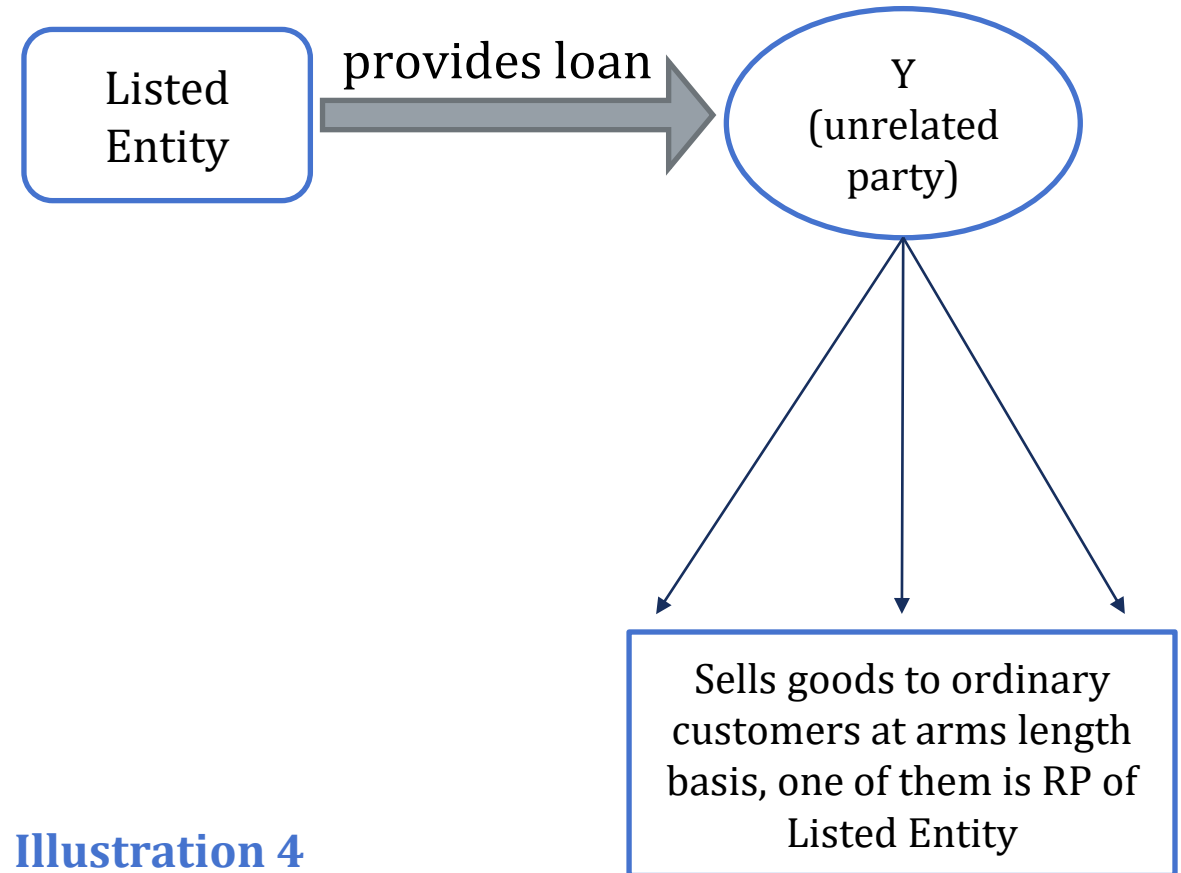


Illustration 4

Decoding P&E | Illustration 5 and 6

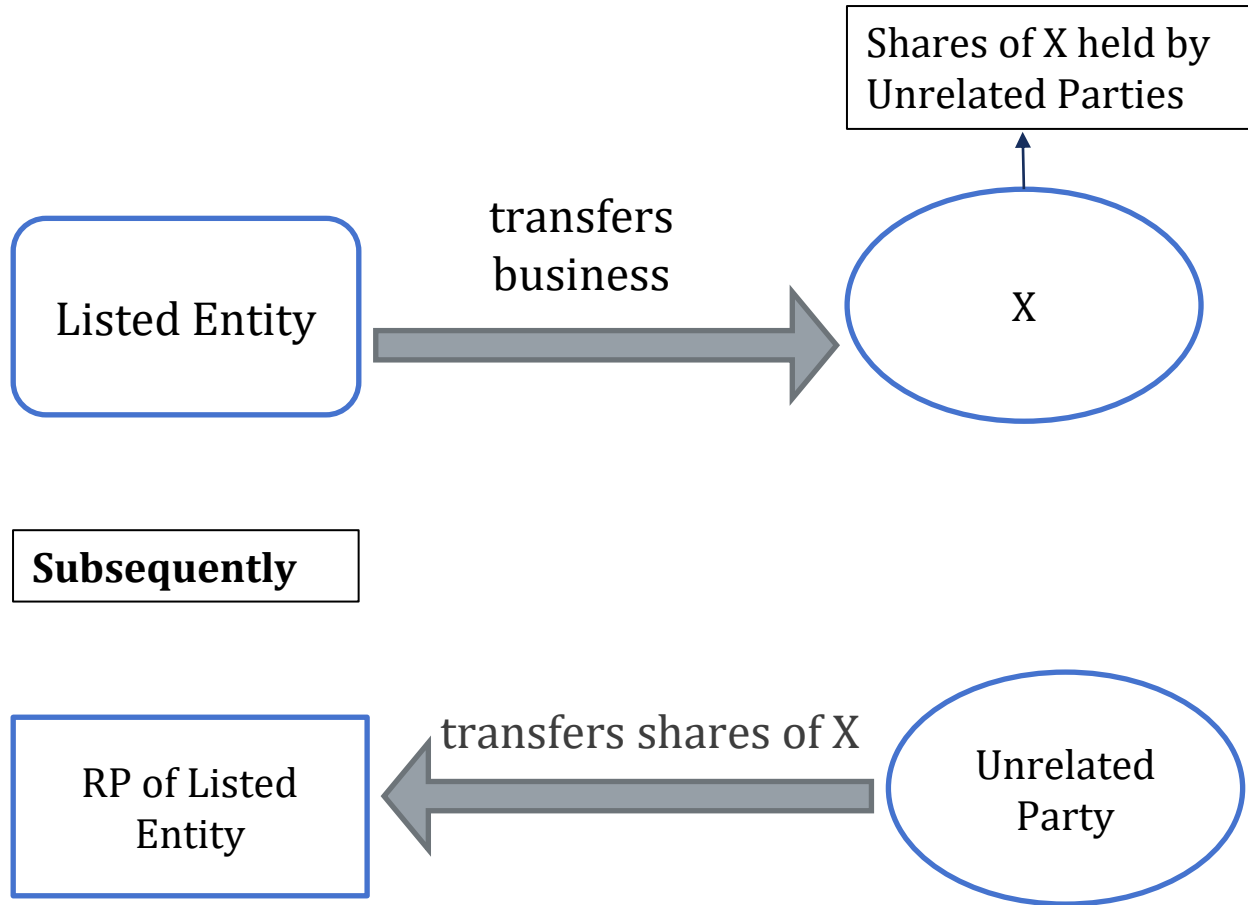
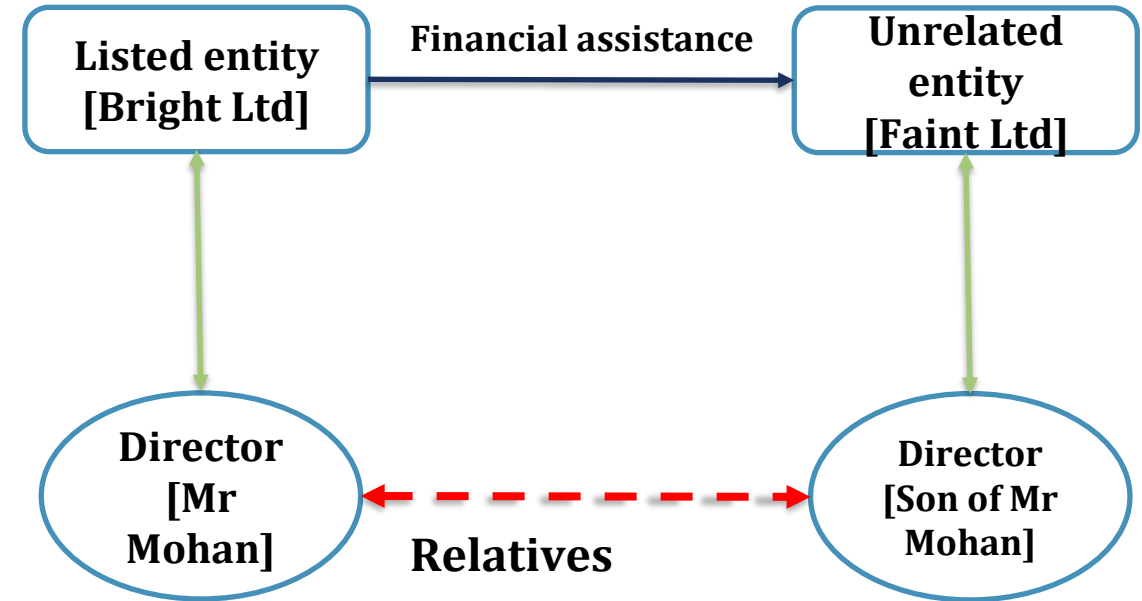


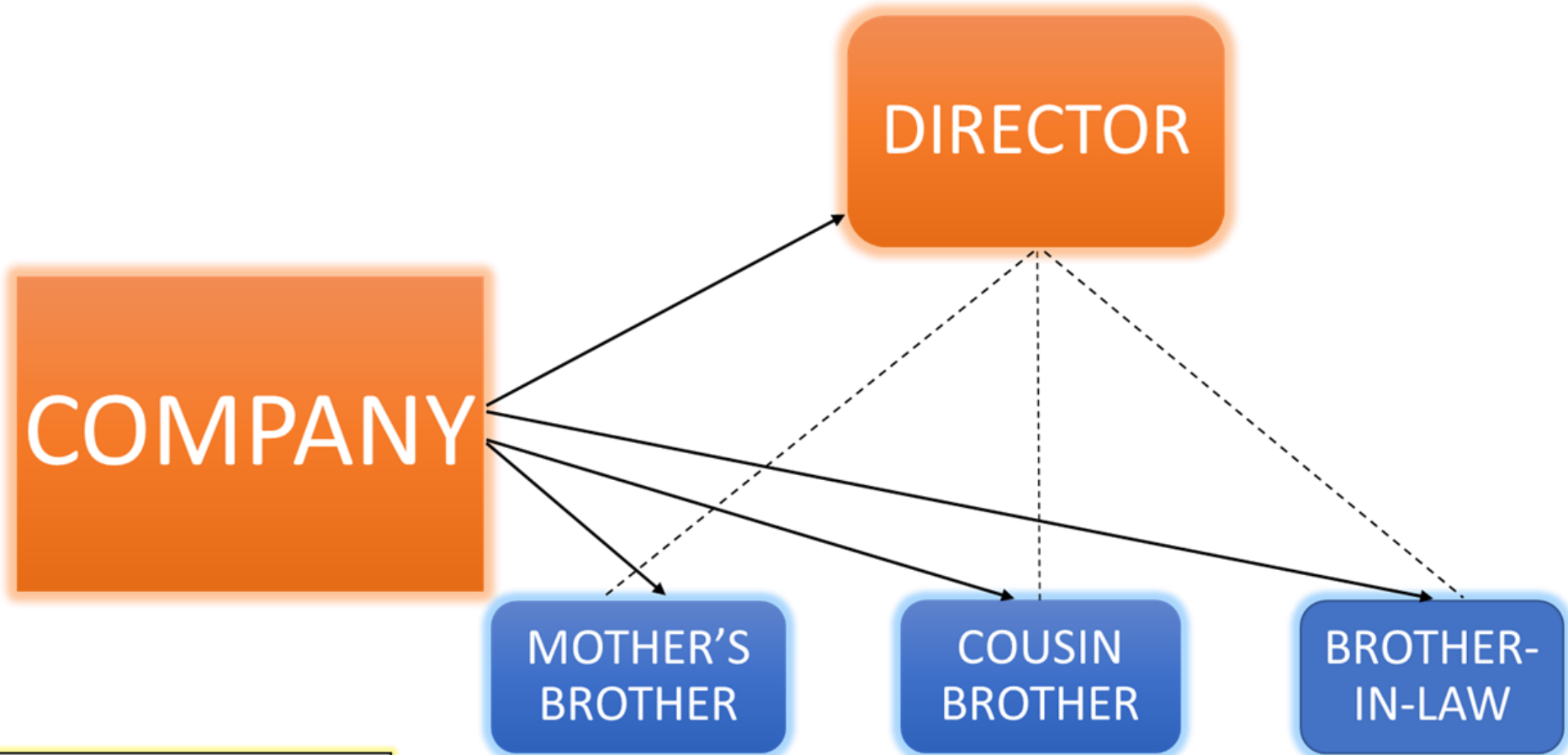
Illustration 5



Will the financial assistance extended by Bright Ltd to Faint Ltd be a related party transaction?

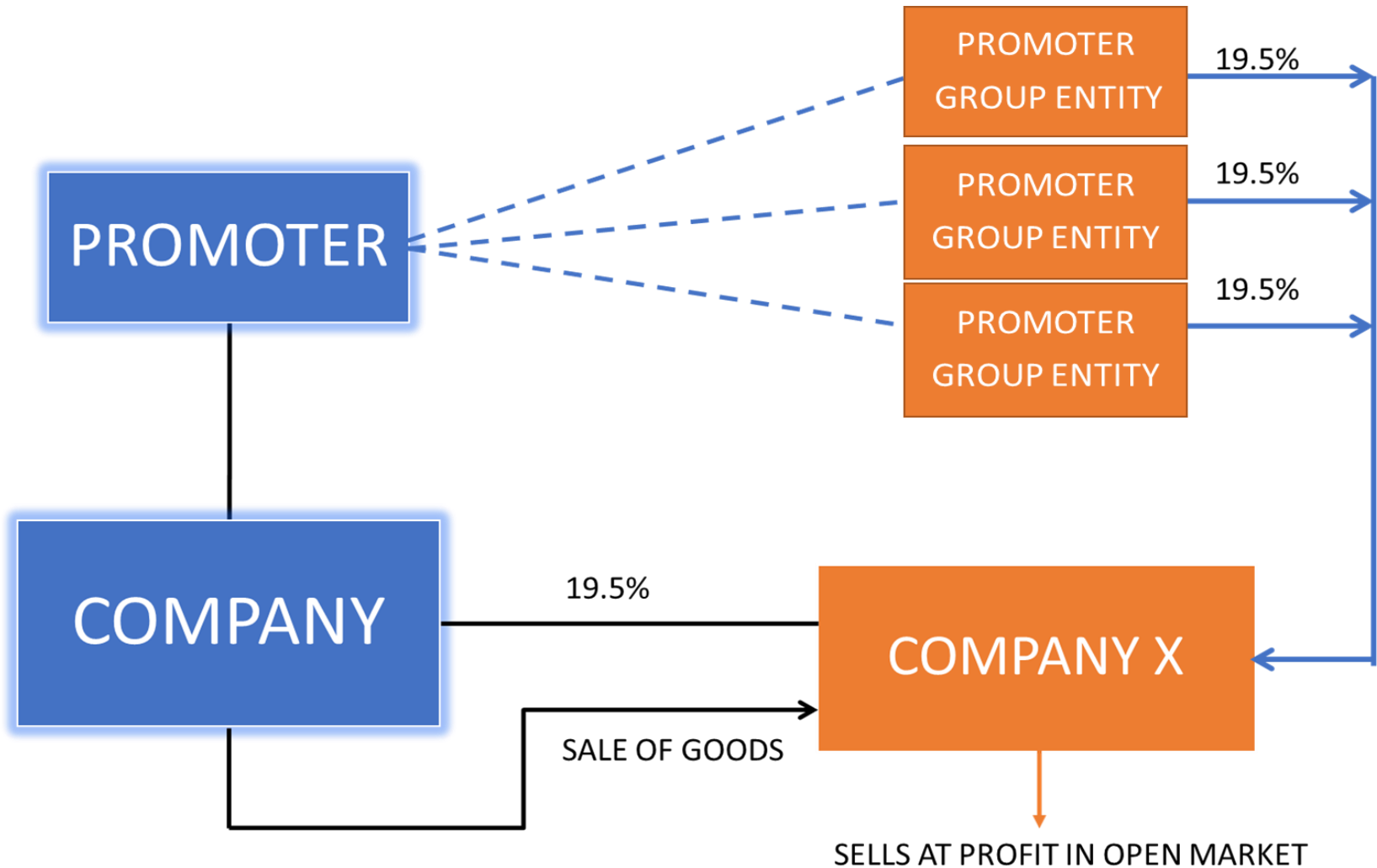
Illustration 6

Decoding P&E | Illustration 7

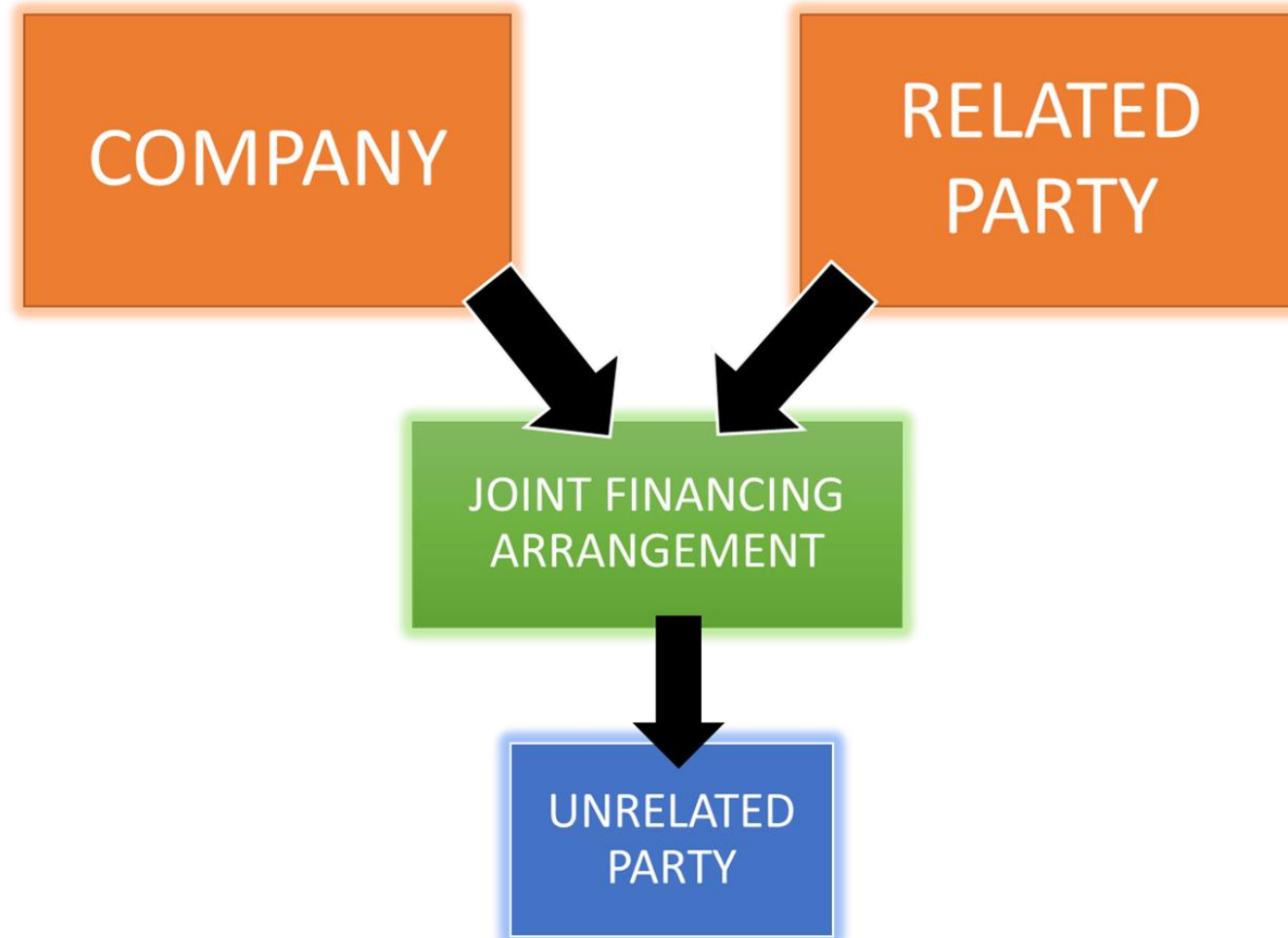


→ TRANSACTION IN THE NATURE OF CONSULTING FEES

Decoding P&E | Illustration 8



Decoding P&E | Illustration 9



Decoding P&E | Illustration 10



SWAP TRANSACTIONS

Intriguing Questions on P&E

- What if there is purpose but no effect, or effect but no purpose?
- For testing effect, how long can the trail be? is it immediate effect or an effect by an extended trail?
- If the effect is to be benefit an RP, but that was not the purpose, does the effect still matter? In essence, does the effect matter without purpose?
- Can one conclude that the purpose and effect test merely uncovers camouflaged transactions?
- Is it possible to have an effective date if the idea is to unravel camouflages?
- Is there a limit of layers upto which we will see purpose and effect? Effect is immediate effect, or ultimate effect:
 - Effect deferred in terms of time
 - Effective deferred in terms of layers

Questions for implementation

- How does audit committee know the purpose/effect?
 - by taking declaration?
 - declaration from whom?
 - Declaration may be taken from whoever is authorising the transaction- say the relevant authority level which is clearing the transactions
- How do companies set controls?
 - by obtaining list of RPs, but the company can never have list of unrelated parties
 - To sort out “related unrelated parties”
- Since the change of regulation at least ignores stop-overs or insulating devices, hopefully, the sensitization of masquerading a related party transaction as unrelated party transaction will be subject to scrutiny.

Undisclosed RPTs - guidance from other standards and jurisdictions



Purpose and effect test in global jurisdictions

- The purpose and effect extension of RPTs clearly emanates from the UK
- The UK definition of RPTs in LR 11.1.5 and DTR 7.3.3. have included the purpose and effect test, effective June 2019
- UK inserted these rules pursuant to SRD II, article 9c
- The consultation paper of FCA (Jan 2019) said the following: We also propose to replicate certain ‘anti-avoidance’ provisions from the existing premium listing regime, for example, to ensure transactions cannot be structured artificially to evade disclosure requirements. While the Directive does not explicitly require these, they have been a useful component of the premium listing regime and so we believe they should be replicated in the new DTR provisions (para 4.26)
- The original language of the LR was as follows:
 - transactions and arrangements between a listed company and any other person that may benefit a related party.
- The premium listing rules (LR) clearly stated that the provision was a safeguard:
 - “The safeguards are intended to prevent a related party from taking advantage of its position and also to prevent any perception that it may have done so.”
- The provision has been described as anti-avoidance provision
- French law also uses a similar term, interposed intermediary, (“personne interposée”), and agreements that indirectly benefit a related party

Substantial property transactions, UK Companies Act 2006

- Sections 190-196 of UK CA 2006 requires shareholders approval for substantial property
- This includes transactions indirectly benefiting connected persons
- The definition of “connected persons” for this purpose is found in sec. 320 of the 1985 law.
- The meaning of “connected person” was interpreted in Granada Group Limited v The Law Debenture Pension Trust Corporation plc [2016] EWCA Civ 1289
- The court took a narrow view of “connected person” and refused to extend the definition to cover person where directors took economic or financial advantage

Definition of RPT in other jurisdictions (1/6)

Global definition

Country	Definition	Comments
<p>UK [Para 11.1.5 of FCA Handbook]</p>	<ul style="list-style-type: none">• Transaction between listed company and RP• Arrangement pursuant to which listed company and RP each invests/ provides finance to other undertaking/ asset• Other similar transaction/arrangement between listed company and any person, the purpose and effect of which is to benefit RP	<p>Similar definition was incorporated in DTR 7.3.3 R: In DTR, a “related party transaction” means:</p> <ol style="list-style-type: none">(1) a transaction (other than a transaction in the ordinary course of business and concluded on normal market terms) between an issuer and a related party; or(2) an arrangement (other than an arrangement in the ordinary course of business and concluded on normal market terms) pursuant to which an issuer and a related party each invests in, or provides finance to, another undertaking or asset; or(3) any other similar transaction or arrangement (other than a transaction or arrangement in the ordinary course of business and concluded on normal market terms) between an issuer and any other person the purpose and effect of which is to benefit a related party.

Definition of RPT in other jurisdictions (2/6)

Country	Definition	Comments
Canada [Source]	<p>Transaction between issuer and RP, whether or not there are other parties too, which results either through itself or with other connected transactions, for the issuer directly or indirectly to –</p> <ul style="list-style-type: none"> - Purchase/acquire asset from RP for valuable consideration/ jointly with RP from third party where asset acquired by issuer < consideration paid for same - Sell/transfer/ dispose asset to RP/ jointly with RP to third party where consideration received < asset disposed - Lease property, issue securities to/from RP - Acquires RP or combines with RP through amalgamation, arrangement etc - Amends terms of security of issuer beneficially owned by RP or vice versa - Assumes/ becomes subject of liability of RP - Borrows/lends/ credit facilities to RP - Cancels / materially amend terms of debt to RP - Provides guarantee/ security/ materially amends terms for RP 	<p>The usual exclusions are there, such as:</p> <ul style="list-style-type: none"> • Transaction between issuer and WOS • Two or more WOS • Business combination • Downstream transaction • Obligated to carry out before the same became a reporting issuer • Rights issue/ dividend distribution etc in compliance with applicable laws

Definition of RPT in other jurisdictions (3/6)

Country	Definition	Comments
USA [Source]	<ul style="list-style-type: none"> • Transaction since last fiscal year or any currently proposed transaction, in which registrant was/is to be a participant - Amount involved > \$120000 - And any RP had/will have direct/ indirect material interest - A transaction includes, but is not limited to, any financial transaction, arrangement or relationship (including any indebtedness or guarantee of indebtedness) or any series of similar transactions, arrangements or relationships. 	<i>This is Item 404 of Reg S-K. There are exclusions given as to where indirect interest shall not be presumed: for example, common directorship</i>
Hong Kong Hong Kong Stock exchange	<p>Connected transactions also include transactions between a group and third parties that may confer benefits to connected persons. They relate to investments in, or financing arrangements with, companies in which the group and its connected person(s) are, or will as a result of the transactions become, shareholders.</p> <p>“Deemed connected person” includes a person who has entered into a transaction, and has “an agreement, arrangement, understanding or undertaking (whether formal or informal and whether express or implied) with a connected person described in paragraph 5(1), (2) or (3) with respect to the transaction;</p>	<i>Several exceptions listed in Section V of the stock exchange guidance, including de minimis transactions, financial assistance, buying or selling of consumer goods, etc</i>

Definition of RPT in other jurisdictions (4/6)

Country	Definition	Comments
<p>Australia <u>Sec. 288 of Corporations Act, 2001</u></p>	<p>An entity is a related party of a public company if the entity acts in concert with a related party of the public company on the understanding that the related party will receive a financial benefit if the public company gives the entity a financial benefit.</p>	<p>NA.</p>
<p>Russia <u>Article 81 of the Federal Law on Joint Stock Companies</u></p>	<p>The said persons shall be deemed interested in the accomplishment of a deal by the company in cases when they themselves, the spouses, parents, children, siblings and half brothers and sisters, step-parents and step-children and/or their affiliated persons:</p> <ul style="list-style-type: none"> ▪ are a party, beneficiary, mediator or representative in the deal; party, beneficiary, mediator or representative in the deal ▪ own (each on his/her own or in their aggregate) 20 and more per cent of the shares (stake, interest) of a legal entity being a party, beneficiary, mediator or representative in the deal; ▪ hold positions in the managerial bodies of a legal entity being a party, beneficiary, mediator or representative in the deal and also positions in the managerial bodies of the management organisation of such a legal entity; ▪ in the other cases stipulated by the charter of the company. 	<p>NA.</p>

Definition of RPT in other jurisdictions (5/6)

Country	Definition	Comments
<p>Singapore (SGX Rulebook - Rule 904)</p>	<ul style="list-style-type: none"> ▪ “interested person transaction” means a transaction between an entity at risk and an interested person. ▪ “transaction” includes:— <ul style="list-style-type: none"> (a) the provision or receipt of financial assistance; (b) the acquisition, disposal or leasing of assets; (c) the provision or receipt of goods or services; (d) the issuance or subscription of securities; (e) the granting of or being granted options; and (f) the establishment of joint ventures or joint investments; <p>whether or not in the ordinary course of business, and whether or not entered into directly or indirectly (for example, through one or more interposed entities)</p> 	<p>NA.</p>
<p>Abu Dhabi (Source)</p>	<p>Subject to Rule 9.5.4, a transaction is a Related Party Transaction if it is a transaction:</p> <p>xxx</p> <p>(c) between the Listed Entity and any other Person, the purpose or effect of which is to benefit a Related Party; or</p>	<p>While inspired by the UK law, this has actually used the expression “purpose or effect”.</p> <p>Similar requirement with the expression “purpose or effect” exists in NASDAQ Dubai</p>

Definition of RPT in other jurisdictions (6/6)

Country	Definition	Comments
<p>France Article 225-38 of Commercial Code</p>	<p>Any agreement entered into directly or through an intermediary between the company and its managing director, one of its deputy managing directors, one of its directors, one of its shareholders holding a fraction of the voting rights greater than 10 % or, if it is a shareholder company, the company controlling it within the meaning of Article L. 233-3 , must be subject to the prior authorization of the Board of Directors.</p> <p>The same applies to agreements in which one of the persons referred to in the preceding paragraph has an indirect interest.</p> <p>According to the Autorité des marchés financiers (Financial Markets Authority), a person should be considered to be “indirectly interested” in an agreement “if, by virtue of his or her links to the parties and of his or her powers to influence their conduct, he or she derives a benefit from it”</p>	<p>Transactions with “Interposed persons”, benefiting a related party, are covered in the definition</p>

Undisclosed RPTs - some global precedents

■ France

- CEO of a certain mutual insurance company in 2017 caused sale of assets to a romantic partner. While the transaction was presented to board, but the auditors did not disclose it, on the ground that the transaction did not fall under definition of “related party”.
- Thales Consultants - board member was also employee of another consulting firm. Head hunting job was assigned to the other consulting firm. Contract was with the board member’s other employer and therefore did not fall under the technical definition. However, Court of Lyon set aside the transaction; ordered refund of money paid: Court of Appeal Lyon 3 Ch B, 22 November 2007, Thales Consultants SA c/ Sarl ARIV, BRDA 2008 n°19, 3.
- According to French Market Authority, 2012, proposition no 22, a person will be indirectly interested, ““if, by virtue of his or her links to the parties and of his or her powers to influence their conduct, he or she derives a benefit from it”

■ USA

- In case of Quadrant 4 System Corp, audit firm Schulman Lobel Zand Katzen Williams & Blackman was held liable for not detecting related party transactions. Transactions apparently split shareholdings and disguised relationships.
- In the case of Friedman LLP SEC described certain “**red flags** “ that indicated undisclosed related party transactions
 - Long and ageing receivable with no collections
 - sale of business outside ordinary course of business
 - common address of the undisclosed related party
- In the case of iFresh, Inc. and and Long Deng the US District Court for the eastern district of New York has taken the bank account operating power as indicator of control.
- In the case of Eagle Bancorp, Inc., a trust was taken as related party, as a related party could significantly influence the management and operations of the trust. Contrary view of the legal adviser was rejected.

Undisclosed RPTs - audit standards

- Para 15 of **ISA 550** requires auditor to have alertness on existence of related party relationships that the management may not have previously disclosed
- Para A22 and A23 of ISA 550 provide indicative circumstances suggesting existence of arrangements with related parties
 - Para A30 etc provide circumstances which are breeding grounds for related party influence; for example, lack of dissent or discussions in meetings, lack of independent review of transactions
- Similar text exists in
 - **SA 550** of ICAI
 - **ASA 550** of Australian AASB
 - **ISA(UK) 550** of FRC
 - **HKSA 550** of Hong Kong
 - **AU-C Section 550** of AICPA
 - **SSA 550** of Singapore
- **AS2410 of PCAOB of the USA** has a complete appendix (Appendix A) listing circumstances that may indicate presence of RPTs previously undisclosed to the auditor
 - this includes absence of commercial substance or absence/ inadequacy of economic substance, transactions with unusual terms etc (*refer next slide*)
 - also provides an indicative list of documents that may be referred to for gathering information on such RPTs
 - includes periodic reports, communications etc from regulators, information available on company's website, tax filings, invoices, record of investments, contracts entered into by the company, reimbursement documentation etc.

Indicators of undisclosed related party transactions - PCAOB

Transactions having unusual/ non-commercial terms

- Buying or selling goods or services at **prices that differ significantly from prevailing market prices;**
- Sales transactions with **unusual terms, including unusual rights of return or extended payment terms** generally not offered;

Transactions not involving any economic substance

- **Borrowing or lending on an interest-free basis or with no fixed repayment terms;**
- **Occupying premises** or receiving **other assets** or rendering or receiving management **services** when **no consideration** is exchanged;
- Engaging in a **non-monetary transaction** that **lacks commercial substance**
- **Sales without economic substance** (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end)

Transactions having one or more irrelevant legs

- **"Bill and hold"** type transactions;
- **Sales at below market rates to an intermediary whose involvement serves no apparent business purpose** and who, in turn, **sells to the ultimate customer at a higher price, with the intermediary** (and ultimately its principals) **retaining the difference;**
- Transactions between two or more entities in which **each party provides and receives the same or similar amounts of consideration** (e.g., round-trip transactions).
- A **subsequent repurchase** of goods that **indicates** that at the time of sale an **implicit obligation to repurchase** may have existed that would have precluded revenue recognition or sales treatment;

Financial arrangements lacking commercial substance

- **Loans to parties** that, at the time of the loan transaction, do **not have the ability to repay** and **possess insufficient or no collateral;**
- **Loans** made **without prior consideration of the ability of the party to repay;**
- **Advancing** company funds that are **used directly or indirectly to pay** what would otherwise be an **uncollectible loan or receivable;**
- **Guarantees** and guarantor relationships **outside the normal course of business;**

Arrangements having potential of undisclosed RPTs - ISA 550

- Participation in **unincorporated partnerships** with other parties
- Agreements for the **provision of services** to certain parties **under terms and conditions that are outside the entity's normal course of business**
- **Guarantees** and guarantor relationships
- **Complex equity transactions**, such as corporate restructurings or acquisitions.
- Transactions with **offshore entities** in jurisdictions **with weak corporate laws**.
- The **leasing of premises** or the rendering of management **services** by the entity to another party if **no consideration** is exchanged.
- **Sales transactions** with **unusually large discounts or returns**.
- Transactions with **circular arrangements**, for example, sales with a commitment to repurchase.
- Transactions under contracts **whose terms are changed before expiry**.

“Purpose or effect” - terminology used in GAAR

- The terminology “purpose or effect” has been used in GAAR for a long time
- Singapore, for example, defines avoidance transaction as one which has the purpose or effect of tax avoidance
- New Zealand has a similar provision
- Generally, a transaction is taken as avoidance transaction if such is (a) the sole motive; or (b) is not merely incidental, and therefore, was done with a view to seek tax avoidance

Meaning of related parties - guidance from other laws and regulations in India



“Associated enterprises” from transfer pricing perspective (1/2)

- The meaning of related party transactions may also get some support from the concept of “associated enterprises” under transfer pricing provisions
- Sec 92A of the Income Tax Act defines “associated 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 indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.
- 92A (2) provides several indicators of associated enterprises
 - The definition covers even situations of economic interdependence
- Similar tests are used by many other jurisdictions as well
- Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year
 - (a) **one enterprise holds**, directly or indirectly, shares **carrying not less than twenty-six per cent** of the voting power in the other enterprise; or
 - (b) **any person or enterprise holds**, directly or indirectly, shares carrying **not less than twenty-six per cent** of the voting power in each of such enterprises; or
 - (c) **a loan advanced** by one enterprise to the other enterprise constitutes **not less than fifty-one per cent** of the book value of the total assets of the other enterprise; or
 - (d) one enterprise **guarantees not less than ten per cent** of the total borrowings of the other enterprise; or
 - (e) **more than half of the board of directors or members** of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, **are appointed by the other enterprise**; or
 - (f) **more than half of the directors or members** of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises **are appointed by the same person or persons**; or

“Associated enterprises” from transfer pricing perspective (2/2)

- (f) **more than half of the directors or members** of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises **are appointed by the same person or persons**; or
- (g) **the manufacture or processing of goods or articles or business carried out** by one enterprise is **wholly dependent on** the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, **of which the other enterprise is the owner** or in respect of which the **other enterprise has exclusive rights**; or
- (h) **ninety per cent or more of the raw materials** and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, **are supplied by the other enterprise**, or by persons specified by the other enterprise, and the prices and other conditions relating to the **supply are influenced by such other enterprise**; or
- (i) **the goods or articles manufactured** or processed by one enterprise, are **sold to the other enterprise** or to persons specified by the other enterprise, **and the prices and other conditions** relating thereto are **influenced by such other enterprise**; or
- (j) **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; or
- (k) where one enterprise is controlled by a Hindu undivided family, **the other enterprise is controlled by a member of such Hindu undivided family** or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or
- (l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds **not less than ten per cent interest** in such firm, association of persons or body of individuals; or
- (m) there exists between the two enterprises, **any relationship of mutual interest, as may be prescribed**.

“Related Person” from GST perspective

- Explanation to Section 15 of CGST Act, 2017 defines RP as

(a) persons shall be deemed to be "**related persons**" if-

(i) such persons are **officers or directors of one another's businesses**;

(ii) such persons are **legally recognised partners in business**;

(iii) such persons are **employer and employee**;

(iv) any person **directly or indirectly owns, controls or holds twenty-five per cent. or more of the outstanding voting stock or shares of both** of them;

(v) one of them **directly or indirectly controls the other**;

(vi) both of them are **directly or indirectly controlled by a third person**;

(vii) together they **directly or indirectly control a third person**;

(viii) they are **members of the same family**;

(b) the term "person" also **includes legal persons**;

(c) persons who are associated in the business of one another in that **one is the sole agent or sole distributor or sole concessionaire, howsoever described**, of the other, shall be deemed to be related.

- Schedule I deals with the activities to be treated as supply even if made without consideration
 - includes supply of goods or services or both between related persons
 - Import of services by a person from a related person or from any of his other establishments outside India

“Related Parties” under IBC (1/2)

Related Party in relation to CD defined u/s 5(24) defines RP as-

- a. a director or partner of the CD or a relative of a director or partner of the CD;
- b. a KMP of the CD or a relative of a KMP of the CD;
- c. an LLP or a partnership firm in which a director, partner, or manager of the CD or his relative is a partner;
- d. a private company in which a director, partner or manager of the CD is a director and holds along with his relatives, more than two per cent. of its share capital;
- e. a public company in which a director, partner or manager of the CD is a director and holds along with relatives, more than two per cent. of its paid- up share capital;
- f. any body corporate whose board of directors, managing director or manager, in the ordinary course of business, acts on the advice, directions or instructions of a director, partner or manager of the CD;
- g. any LLP or a partnership firm whose partners or employees in the ordinary course of business, acts on the advice, directions or instructions of a director, partner or manager of the CD;
- h. any person on whose advice, directions or instructions, a director, partner or manager of the CD is accustomed to act;
- i. a body corporate which is a holding, subsidiary or an associate company of the CD, or a subsidiary of a holding company to which the CD is a subsidiary;
- j. any person who controls more than twenty per cent. of voting rights in the CD on account of ownership or a voting agreement;
- k. any person in whom the CD controls more than twenty per cent. of voting rights on account of ownership or a voting agreement;
- l. any person who can control the composition of the board of directors or corresponding governing body of the CD;
- m. any person who is associated with the CD on account of-
 - (i) participation in policy making processes of the CD; or
 - (ii) having more than two directors in common between the CD and such person; or
 - (iii) interchange of managerial personnel between the CD and such person; or
 - (iv) provision of essential technical information to, or from, the CD;

“Related Parties” under IBC (2/2)

- On similar lines with other laws, IBC too puts certain limitations on related parties-
 - a financial creditor, being a related party is not entitled to the right of representation, participation or voting in the meetings of Committee of Creditors [Proviso to 21(2)];
 - Related parties of ineligible persons are barred from submitting a resolution plan under section 29A.
- However, there is no explicit provision requiring separate treatment of a creditor being a related party while determining the liquidation value payable to such creditor
 - Waterfall mechanism does not provide for any differentiation between a related creditor and an unrelated creditor
 - For instance, an unsecured financial creditor (whether related/unrelated) is placed above an ordinary operational creditor
- Non-discrimination between related & unrelated creditors while determining the liquidation value by itself, becomes a gateway for misuse of law by related parties
 - NCLT Allahabad in *J.R. Agro Industries P. Limited v. Swadisht Oils P. Ltd* observed that “if claim of related party is given priority over operational creditors, it would not be just to operational creditor”
- Although, there must be a present relationship between FC and CD to exclude the FC from the CoC. However, if the same leads to absurdity, even past relationship counts
 - SC in *Phoenix Arc Private Limited v. Spade Financial Services Limited & Ors.* held that “while the default rule under the first proviso to Section 21(2) is that only those financial creditors that are related parties in praesenti would be debarred from the CoC, those related party financial creditors that cease to be related parties in order to circumvent the exclusion under the first proviso to Section 21(2), should also be considered as being covered by the exclusion thereunder”



Practical guide to RPTs qualifying P&E test



Practical guide to transactions qualifying P&E test

- Point of engineering of transactions involving P&E
 - the **beneficiary related party**
 - **assumes primary responsibility** of ensuring that RPTs are not camouflaged as non-RPT
- LE may **seek confirmation** from all RPs that
 - they are not aware of any such camouflaged transactions
 - either engineered by them or on their behest
 - whose purpose and effect is to provide benefits to them
- **Requires sensitisation of RPs** wrt RPT provisions
 - beneficiary will always be suspected of having knowledge of such transactions undertaken for his benefit
- **Moving from “related parties” to their connected parties**
 - tagging transactions with unrelated but connected parties
 - connected parties would generally mean either ‘interested parties’ or distant related parties’
- Unusual transactions or “**smoke and fire test**”
 - uncommercial terms
 - unusual terms
 - oblivious transactions
- **Examining trading partners** and checking for impact on relationships
 - examining the frequency or volume of transactions with a particular party
 - identifying the ones with whom high volume and value of transitions have taken place

Role of audit committee

- **Role of the Audit Committee**
 - similar to that of auditor
 - LE remains the auditee
 - has to keep watchful eyes on such transactions that signal some benefit passing on to RPs indirectly
 - AC shall follow the approach of constructive skepticism
 - may refer to the transactions as per past history of LE
- The Guidebook for Audit Committee in Singapore by MAS provides guidance for Audit Committee (AC) in relation to compliance with RPT/IPT;
 - AC should have regard to commercial substance and not just form and technicality, in applying the Listing Manual on IPTs.
 - The AC could also designate the Internal Auditor to ensure that the procedures under the framework are followed and to require the Internal Auditor to report to the AC on a quarterly basis.
- Where there are such indications of potential IPTs, the AC should require Management to provide additional information on the transactions and the background of the trading partners to satisfy itself whether the transaction might be a RPT or an IPT where:
 - The trading partner is both a supplier and a customer
 - The terms offered to the trading partner are generous or not at market rates
 - The trading partner is incorporated in a tax haven with little or no infrastructure.
- The AC could encourage the Executive Chairman and the CEO to discuss with the AC transactions with parties where they have a relationship that falls outside of the 'interested person' definition set out in the Listing Manual.

Consequences of detecting undisclosed RPTs

- Is it an anti-avoidance provision, designed to curb malpractices, or we are hoping to net in some transactions?
 - The transactions, if any, found under the P&E test is nothing short of an anti-avoidance.
 - The presence of transactions under P&E test will raise serious questions and concerns on the related party who is benefitting from such transaction as well as the overall framework of internal control of the company
- Impact on integrity of financial statements
 - question on the integrity and accuracy of the internal financial controls
 - incomplete disclosure of RPTs under the notes to financial statements
- Impact on RPT approvals

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