

TAX FLASH NEWS

Benefit of carry forward and set-off of business losses for previous years shall be available if 51 per cent of the control and voting power of the company remains unchanged

Background

Recently, the Karnataka High Court (High Court) in the case of AMCO Power Systems Ltd.¹ (the taxpayer) upheld the decision of the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) that the benefit to carry forward and set-off business losses for previous years shall be available if 51 per cent of the control and voting power of the company remains unchanged.

Facts of the case

- The taxpayer is a company engaged in the manufacture and sale of storage batteries. Up till Assessment Year (AY) 2000-01, all the shares of the taxpayer were held by AMCO Batteries Limited (ABL). In the AY 2001-02, the holding of ABL in the taxpayer was reduced to 55 per cent, and the remaining 45 per cent shares were transferred to a subsidiary of ABL, namely AMCO Properties and Investments Limited (APIL). In the AY 2002-03, ABL further transferred 49 per cent of its remaining 55 per cent shares to Tractors and Farm Equipments Limited (TAFE), and consequently ABL retained only 6 per cent shares while its subsidiary APIL held 45 per cent shares. A similar shareholding continued for the AY 2003-04.
- The taxpayer filed its return of income for AY 2003-04 offering nil income after setting off losses brought forward from earlier years.

- On scrutiny assessment, the set-off of losses of the previous years against the income of AY 2003-04 was disallowed invoking Section 79 of the Income-tax Act, 1961 (the Act). The taxpayer preferred an appeal before the Commissioner of Income -tax (Appeals) [CIT(A)] for the denial of set-off of brought forward business loss.
- The CIT(A) upheld the order of the Assessing Officer (AO) and held that the taxpayer was not entitled to set-off the brought forward losses, considering the change in the beneficial holding of 51 per cent or more, as provided under Section 79 of the Act.
- Aggrieved by the order of the CIT(A), the taxpayer filed an appeal before the Tribunal and the Tribunal allowed the benefit of set-off of brought forward losses to the taxpayer. The Tribunal held that 51 per cent of the voting power was beneficially held with ABL during the AYs 2002-03 and 2003-04, and would thus be entitled to carry forward and set-off business losses for the previous years.

Tax department's contentions

- The voting power of ABL in the taxpayer was reduced from 55 per cent to 6 per cent, and the remaining 94 per cent was held by TAFE (49 per cent) and APIL (45 per cent).
- The taxpayer thus would not be entitled to carry forward and set-off business losses in the AYs 2002-03 and 2003-04.

¹ CIT v. AMCO Power Systems Ltd (Karnataka High Court) (ITA No.766 OF 2009 c/w ITA Nos.769/2009, 1046/2008,765/2009 & 767/2009)

- It was further submitted that even though APIL may be a wholly owned subsidiary of ABL, both the companies would be separate entities and cannot be clubbed together. By transfer of its 49 per cent shares to TAFE, the shareholding of ABL was reduced to only 6 per cent, and the provisions of Section 79 of the Act would be attracted, denying the benefit of carry forward of business losses to the taxpayer.

Taxpayer's contentions

- The voting power which was held by the person or persons who beneficially held shares of the company is to be taken into consideration since the shareholding pattern is distinct from the voting power.
- It was further submitted that because APIL was a wholly owned subsidiary of ABL and fully controlled by it, although the shareholding of ABL had been reduced to 6 per cent, the voting power of ABL remained at 51 per cent and therefore, the provisions of Section 79 of the Act would not be attracted.

High Court's ruling

- ABL had complete control over APIL, which is its wholly owned subsidiary. Though the shareholding of ABL reduced to 6 per cent, yet by virtue of it being the 100 per cent holding company of APIL, the voting power of ABL cannot be said to have been reduced to less than 51 per cent, because together, both the companies hold a voting power of 51 per cent.
- The purpose of Section 79 of the Act would be that the benefit of carry forward and set-off of business losses for previous years should not be misused by any new owner, who may purchase shares of the company, only to get the benefit of set-off of business losses of the previous years. For such purpose, it is provided under the said Section that 51 per cent of the voting power which was beneficially held by a person or persons should continue to be held, only then can such benefit be given to the company.
- It was ruled that though ABL may not have continued to hold 51 per cent shares, Section 79 speaks of 51 per cent voting power, which ABL continued to have even after transfer of 49 per cent shares to TAFE, as it controlled the voting power of APIL, and together, ABL had 51 per cent voting

power. Reliance was also placed on decision in the case of *Italindia Cotton Private Limited*² where the apex court held that the Section would be applicable only when there is a change in shareholding in the previous year which may result in a change in control of the company and that every such change of shareholding need not fall within the prohibition against the carry forward and set-off of business losses.

- Meaning thereby, the control of the company remained with ABL as the change in shareholding did not result in a reduction of its voting power to less than 51 per cent.

Our comments

The issue whether the benefit of carry forward and set off of business losses for previous years can be availed on a change in shareholding has been a matter of debate. This is a welcome ruling by the Karnataka High Court wherein it observed that a change in the shareholding of the company is distinct from the control and voting power of a company.

This decision effectively implies piercing the corporate veil for the purposes of determining the beneficial shareholding and control over the company.

In this context, it may be pertinent to note that the Mumbai Tribunal in case of *Just Lifestyle Private Limited*³ held that a company is a distinct legal entity and denied the benefit of carry forward and set-off of business losses, holding that a change in the beneficial shareholding would be triggered even if shares representing 51 per cent of the voting rights remained within the same group. On a different set of facts, in another ruling, the Mumbai Tribunal in case of *Tainwala Trading and Investments Company Limited*⁴ denied the carry forward of business losses on account of a change in legal ownership. However, these decisions have not been referred to or considered by the Karnataka High Court while pronouncing its judgement.

This ruling sets aside the separate legal entity concept disregarding the legal ownership of shares and could positively benefit companies contemplating internal group reorganisation, resulting in a change in the shareholding of more than 49 per cent.

² CIT v. *Italindia Cotton Private Limited* [1988] 174 ITR 160 (SC)

³ *Just Lifestyle Pvt. Ltd. v. DCIT* (ITA No. 2638/Mum/2012) -Taxsutra.com

⁴ *Tainwala Trading and Investments Company Limited* (ITA No. 5120/Mum/2009)

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