Carry forward and set off of unabsorbed losses permissible even if shareholding changes by more than 49%, so long as there is no change in control

October 30, 2015

In brief

The Karnataka High Court (HC) in the taxpayer's case has held that it would be entitled to carry forward and set-off unabsorbed losses even though immediate shareholding had changed by more than 49%, so long as there is no change in control.

In detail

Facts of the case

- The taxpayer[1] was a wholly owned subsidiary of Company A and had unabsorbed tax losses. During Financial Year (FY) 1, Company A transferred 45% of the taxpayer's shareholding to another wholly owned subsidiary, Company B.
- Subsequently, during FY 2, Company A transferred 49% of taxpayer's shareholding to a third party and therefore, its direct shareholding in the taxpayer company was reduced to 6%.
- As a result of the above transfer, Company A, along with its wholly owned subsidiary Company B, held 51% stake in the taxpayer company and the balance 49% was held by a third party.
- In the subsequent year, the taxpayer had set off its unabsorbed losses against its income.
- As per the Income-tax Act (IT Act), unabsorbed losses of a closely held company could not be carried forward and set off against the income of succeeding years, if 51% of the voting power was not beneficially held by persons who beneficially held shares in the year in which the losses were incurred, i.e., there was a change in beneficial shareholding by more than 49%.
- The Tax Officer and First Appellate Authority disallowed the above set-off of losses owing to the change in the taxpayer's shareholding by more than 49%.
- However, the Appellate Tribunal allowed the set off of unabsorbed losses in view of the fact that 51% of the voting power was beneficially held by Company A, along with its wholly owned subsidiary Company B.

Issue before the HC

- Will the taxpayer be entitled to carry forward and set off business losses despite a change in immediate shareholding of the taxpayer by more than 49%?

[1] [TS-607-HC-2015(KAR)]

Taxpayer's contentions

- It was not the shareholding that has to be taken into consideration, but the voting power that was held by persons who **beneficially** held more than 51% shares of the taxpayer.

- Since Company A held and controlled 100% stake in Company B, the voting power of Company A remained at 51% and accordingly, the provisions of the IT Act disallowing loss pursuant to change in shareholding were not applicable.

Tax authorities' contentions

- The shareholding of Company A was reduced to less than 51% during FY 2.

- Even though Company B was a wholly owned subsidiary of Company A, both the companies were separate entities and could not be clubbed together.

HC ruling

- The condition of the continuation of 51% beneficial voting power was to prevent the misuse of carry-forward and set-off of losses by a new owner who could purchase the shares only to avail the benefit of set-off of business losses of previous years to reduce the tax liability on profits earned.

- Provisions of the IT Act provide for 51% voting power, which Company A continued to hold in the taxpayer-company, even after the transfer of 49% stake to a third party, as it controlled 100% voting power of Company B.

- Therefore, the voting power of Company A was not reduced to less than 51%, as Company A, together with Company B, had voting power of 51% in the taxpayer company.

- The Supreme Court, in the case of Italindia Cotton,[2] had held that the provisions of the IT Act would be applicable only when a change in shareholding resulted in a change in control of the company.

- In the present case, though there was a change in shareholding, there was no change in the control of the taxpayer company, and the disallowance of carry forward and set off of losses pursuant to change in shareholding would not be attracted.

The takeaways

This ruling may be pertinent for companies undertaking group restructuring.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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[2] CIT *v.* Italindia Cotton Co. Private Limited (1998) 174 ITR 160 (SC)

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