Transfer of unabsorbed losses permissible if amalgamating company in business for three or more years even if business units engaged for less than three years; Activities for setting up of business also construed as "engaged in business"

November 6, 2015

In brief

The Karnataka High Court (HC), while allowing set off of unabsorbed loss of the taxpayer acquired on amalgamation, has held that unabsorbed losses pertained to the amalgamating company as a whole, and not to any division. It was the amalgamating company that should have been engaged in business for three or more years prior to amalgamation.

In detail

Facts of the case

- The taxpayer[1] had entered into a scheme of amalgamation wherein Company A was amalgamated with the taxpayer.
- Company A had two businesses:
  - Business 1 : Was in existence for more than three years at the time of amalgamation, and had unabsorbed losses
  - Business 2 :
    - Activities for setting up business like obtaining licenses, loans, construction, etc. had commenced for more than three years at the time of amalgamation
    - However, operations had started for less than three years at the time of amalgamation
    - There were unabsorbed losses pertaining to Business 2
- Post amalgamation, the taxpayer had set off unabsorbed tax losses of Company A against its income.
- As per the Income-tax Act (IT Act), unabsorbed losses of amalgamating company were allowed to be carried forward and set off by the amalgamated company only if the amalgamating company had been **engaged in the business** in which accumulated loss was incurred, for three or more years.

[1] ITA 773/2009

- The Tax Officer disallowed the aforementioned set-off as the unabsorbed losses pertained to Business 2 (which was in existence for less than three years). However, the first appellate authority and the Appellate Tribunal both allowed the above set-off of unabsorbed losses.

Issue before the HC

- Whether the condition of being "engaged in the business in which accumulated loss was incurred for three or more years" included the period of setting up of business, or had to be computed from date of commencement of actual production

- Whether the taxpayer would be entitled to transfer of unabsorbed loss pertaining to Business 2, in view of the fact that operations of the business had commenced less than three years prior to amalgamation

Taxpayer's Contentions

- The IT Act provided for accumulated losses of the amalgamating company, and not of individual units of the company, as "amalgamating company" had to be seen as a whole, and not unit-wise.

- Alternatively, even if Business 2 was considered separately, benefit of unabsorbed loss had to be given, as Company B was engaged in Business 2 for more than three years, even though the operations had commenced for less than three years.

Department's Contentions

- Even though activities for establishing Business 2 may have commenced earlier, the benefit of transfer of unabsorbed loss had to be granted to the taxpayer only if Business 2 had commenced operations more than three years prior to amalgamation.

- 'Three years' for the purpose of carry forward and set-off of accumulated losses had to be taken from the period of actual commencement of operations of the business, and not from the date when activities for establishing the business had commenced.

- Analogy could also be drawn from the IT Act relating to depreciation, wherein depreciation was allowed only when the asset was actually used for the purpose of business.

HC Ruling

- 'Engaged in business' was different from 'commencement of business'. A party was said to have engaged itself in a particular business from the day it got involved in setting up of the business.

- Use of the word, 'used' in the depreciation provisions meant used after the business commenced. This only clarified that the phrases, 'commencement of business' and 'engaged in business' were different.

- The phrase, 'commencement of business' may apply to provisions relating to depreciation, but the phrase, 'engaged in business' applied to transfer of unabsorbed losses.

- Engagement of Company A in Business 2 had begun from the date it undertook activities required for establishing the business, and the same had been duly reflected in Company A's books of accounts.

- On facts, it could not be disputed that engagement of the amalgamating company in Business 2 had begun more than three years prior to amalgamation, though commencement of operations of business had happened less than three years earlier.

- Even otherwise, the amalgamating company itself had to be in the business for more than three years prior to amalgamation, and not a particular unit of the amalgamating company.

- Since Company A was engaged in business for more than three years, the benefit of transfer of unabsorbed loss to the amalgamated company would be available.

- As provisions relating to transfer of unabsorbed losses in an amalgamation was a beneficial provision, it should be liberally interpreted in favour of the taxpayer.

- In the present case, the taxpayer would be entitled to the benefit of transfer of unabsorbed losses.

The takeaways

This judgment may be pertinent to companies having unabsorbed tax losses, and are/ will be involved in a scheme of amalgamation.

Let's talk

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

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