Tax Insights

18 July 2022

Tribunal denies set-off of losses upon demerger since the sole purpose of demerger was to avail tax benefits

In brief

The Pune bench of the Income-tax Appellate Tribunal (Tribunal)[1] allowed the Revenue's appeal and denied the set-off of brought forward business losses and unabsorbed depreciation pertaining to the demerged undertaking claimed by the taxpayer. This was so as the scheme of demerger was undertaken solely for the purpose of obtaining tax benefit.

In detail

Facts

- The taxpayer was engaged in the business of sale of diesel engines. Pursuant to the order of the Bombay High Court, an undertaking of the 100% subsidiary of the taxpayer was demerged and vested with the taxpayer with effect from 1 April 2005.
- The taxpayer had filed the tax return for the assessment year 2006-07 showing income of INR 550 million. The taxpayer filed revised tax return in the financial year 2007-08 after set-off of brought forward business losses and unabsorbed depreciation pertaining to the demerged undertaking and showing a lower income of INR 300 million.
- The Tax Officer (TO) found that the assets of the demerged undertaking were shown as held for sale in the balance sheet at on 31 March 2006. Therefore, the TO inferred that the taxpayer had no intention to continue the business of demerged undertaking.
- Accordingly, the TO concluded that the scheme of demerger was not for a genuine purpose as contemplated and issued the assessment order on 30 December 2009 disallowing the set-off of brought forward business losses and unabsorbed depreciation, pertaining to the demerged undertaking, under section 72A of the Income-tax Act, 1961 (the Act).
- The taxpayer filed an appeal against the order of the TO before the Commissioner of Income-tax (Appeals) (CIT(A)). The CIT(A) allowed the appeal of the taxpayer stating that the TO has no jurisdiction to evaluate the purpose and motive of the demerger once it is approved by the Bombay High Court. Further, in the

[1] ITA No. 2121/PUN/2017

absence of any notification by the Central Government, as provided under sub-section (5) of section 72A of the Act, the TO cannot apply its own guidelines to decide the genuineness of the demerger.

Revenue's contention

- The assets vested with the taxpayer pursuant to the scheme of demerger were shown as 'held for sale' in the financial statements as on 31 March 2006. Accordingly, the scheme of demerger was only to avail the tax benefit and not for a genuine purpose.
- Even though the Central Government has not prescribed any conditions to determine the genuineness of demerger, as the material on record establishes that the scheme of demerger is not for a genuine purpose, the taxpayer should not be entitled for benefit of set-off of brought forward business losses and unabsorbed depreciation.

Taxpayer's contention

- In absence of any guidelines or conditions for the purpose of determining the genuineness of the demerger, it is beyond the scope for the TO to determine the purpose genuineness of the demerger.
- The scheme of demerger approved or sanctioned by the High Court is binding on everyone including the authorities of the income-tax department.

Tribunal's ruling

- The material on record indicates that the taxpayer had no intention to continue the business of the demerged undertaking and had not carried on any business of the demerged undertaking after the sanction of demerger by the High Court on 12 January 2007.
- The provisions of the Act have prescribed the conditions under which the set-off of brought forward business losses can be allowed in the case of amalgamation and demerger, etc. The mere fact that the demerger was sanctioned by the High Court does not entitle the taxpayer to claim the benefit of the set-off of brought forward business losses.
- Unlike the conditions stipulated under section 72A(2) of the Act for availing the benefit of set-off of brought forward business losses on amalgamation, there are no conditions prescribed for demerger under the provisions of section 72A(5) of the Act by the Central Government to determine the genuineness of the demerger.
- The Tribunal referred to the decision of the Delhi High Court in the case of IEL Limited[2] and Bombay High Court in the case of Ballarpur Industries Limited[3], wherein it was held that the benefit of section 72A cannot be availed if the sole purpose of the amalgamation was only to avail the benefit of carried forward business losses and unabsorbed depreciation losses.
- The Tribunal held that there is no difference in the object behind the enactment of provisions governing the scheme of amalgamation and the provisions governing the case of demerger. The objective behind enactment of section 72A as explained in the memorandum explaining the provisions of Finance (No.2) Bill of 1997 and by the Supreme Court in the case of CIT v. Mahindra & Mahindra Limited[4] is the revival of sick units and relieving the government of an uneconomical burden of taking over the sick units by way of offering incentives for the merger of sick industrial units with robust companies.
- Furthermore, section 72A(5) of the Act has been enacted to empower the TO to deny the benefit of set-off of brought forward business losses and unabsorbed depreciation contrary to the objective behind the provisions of section 72A of the Act.
- The fact that the Government of India has not laid down the criteria to determine the genuineness of the demerger does not alter the position settled in the case of Ballarpur Industries Limited[3], i.e. the benefit of set-off of brought forward business losses and unabsorbed depreciation cannot be allowed for sole purpose to avail the benefit of set-off of brought forward business losses and unabsorbed depreciation.

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2 IEL Limited *v.* Union of India [1992] 195 ITR 232 (Delhi)

3 Ballarpur Industries Limited *v.* CIT [2017] 398 ITR 145 (Bombay)

4 CIT *v.* Mahindra & Mahindra Limited [1983] 144 ITR 225 (SC)

- Accordingly, as the business of the demerged undertaking was not continued and the scheme of demerger was carried out only with the sole objective to avail the benefit of set-off of losses, the order of CIT(A) was reversed and the set-off of brought forward business losses and unabsorbed depreciation of the demerged undertaking, claimed by the taxpayer was denied.

The takeaways

The Tribunal denied the benefit of set-off of brought forward losses and unabsorbed depreciation in case of the demerger sanctioned by the High Court upon finding that the main purpose of the scheme of demerger was to avail tax benefits. It categorically stated that, even if no conditions or guidelines are prescribed by the Central Government under section 72A(5) of the Act to determine the genuineness of the demerger, the TO can deny the benefit of carry forward and set-off of business losses and unabsorbed depreciation under section 72A(4) of the Act if the objective of the demerger is to only avail the benefit of set-off of brought forward business losses and unabsorbed depreciation.

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