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EY Tax Alert

Kolkata Tribunal rules losses adjusted in the books under corporate reorganization are available for set off in computing book profit under MAT provisions



Executive summary

This Tax Alert summarizes a recent ruling of the Kolkata Income Tax Appellate Tribunal (Tribunal) in the case of J. K. Lakshmi Cement Ltd. (Taxpayer) v. ACIT [ITA No. 1275 of 2010] on the issue of whether set off of past year's book losses is available for Minimum Alternate Tax (MAT) purposes, if pursuant to a corporate reorganization the losses are set off in books against reserves. The MAT provision permits set off of past year's losses as per books of account. In the facts of the case, the Tribunal held that such book losses are available for set off against book profits of subsequent years in view of the comment by the statutory auditors that the set off against reserves in the books was against the Generally Accepted Accounting Practices (GAAP). The Tribunal held that the book profit for MAT purposes needs to be computed as per requirements of the Indian Company Laws (ICL) and GAAP. Therefore, even though the accounting treatment in the books was under the mandate of a High Court (HC) order sanctioning the reorganization, it was not binding for MAT purposes and the book losses determined on correct application of GAAP need to be considered.

Background

- ▶ MAT provisions, inserted by Finance Act, 2000, substituting the erstwhile comparable provision, apply to a company and provide for taxation based on book profit. Taxation under MAT provisions is triggered when tax liability, computed at a specified percentage of book

profit^[1], is higher than that under the normal computation.

- ▶ The book profit is computed by adopting the net profit as per Profit and Loss Account (P&L a/c), prepared in compliance with the relevant provisions of the ICL and further adjusting it by upward and downward adjustments as specified under MAT provisions.
- ▶ One of the specified downward adjustments is in respect of lower of the loss brought forward or the unabsorbed depreciation as per books of account. Such downward adjustment is subject to these conditions viz., (a) The loss shall not include depreciation.(b) The downward adjustment is not permissible if the amount of loss brought forward or unabsorbed depreciation is nil.

Facts

- ▶ The Taxpayer had incurred losses till tax year 1999-00 and there was a debit balance in its P&L a/c.
- ▶ The Taxpayer underwent an internal corporate reorganization in tax year 2000-01, approved by its shareholders and creditors and sanctioned by the HC. Pursuant to the sanctioned scheme of the reorganization, the Taxpayer set off the debit balance in the P&L a/c with credit balance in Share premium and Revaluation reserve a/c. Thus there were no losses appearing in its books of account.

^[1] Currently 18.5% (excluding surcharge and education cess)

- ▶ In their audit report for tax year 2000-01(i.e., the year of reorganization), the statutory auditors commented that the set off against Share premium and Revaluation reserve a/c was against GAAP but was implemented by the Taxpayer in view of the binding HC order.
- ▶ For tax years 2005-06 and 2006-07, while computing book profit for MAT purposes, the Taxpayer set off the past years' book losses as would have been carried forward but for the set off in terms of the scheme of reorganization. In other words, the Taxpayer claimed the past years' book losses as deductible for MAT purpose though in the books they were set off against Share premium and Revaluation reserve a/c.
- ▶ The Tax Authority disallowed the Taxpayer's claim and computed the book profit without granting set off for the past years' losses.
- ▶ On appeal by the Taxpayer, the First Appellate Authority gave conflicting decisions. He allowed the Taxpayer's appeal for the tax year 2005-06 but rejected the appeal for tax year 2006-07. Hence, both the Taxpayer and Tax Authority appealed further to the Tribunal.

Taxpayer's contentions

- ▶ For MAT purposes, what is relevant is the book profit computed as per requirements of the ICL and GAAP.

- ▶ In the facts of the present case, the treatment accorded in the books of account in tax year 2000-01 of set off of accumulated loss against reserves under the mandate of the HC order is not relevant since the statutory auditors had qualified the treatment as not in accordance with GAAP in their audit report for that year.
- ▶ For MAT purposes, the Tax Authority should consider the position as would prevail had the correct accounting treatment of not setting off the loss against reserves been followed.
- ▶ Although the Supreme Court, in the case of Apollo Tyres Ltd. v. CIT^[2] (Apollo Tyres ruling), had held that book profit, as computed under the ICL and approved by statutory auditors, shareholders and the Registrar of Companies (ROC), is binding on the Tax Authority, subject only to statutorily permitted adjustments, in the present case, the ratio is not applicable in view of the qualification by the statutory auditors that the accounting treatment is contrary to GAAP.
- ▶ Reliance was placed on the Mumbai Tribunal ruling in the case of DCIT v. Bombay Diamond Co Ltd. ^[3](Bombay Diamond ruling) in support of the proposition that where the accounts were not prepared in accordance with the ICL, the Tax Authority has powers to go beyond book profit as per audited accounts.

^[2] [255 ITR 273]

^[3] [33 DTR 59](Trib)

Tax Authority's contentions

- ▶ The Apollo Tyres ruling confirms that the Tax Authority has no power to go beyond the book profit as per audited accounts except for statutorily permitted adjustments.
- ▶ The downward adjustment for set off of past years' book losses can be made only if such losses appear in the books of account. In the Taxpayer's case, the books of account did not reveal any losses since they were set off against reserves in terms of the mandate of the HC order sanctioning the reorganization in tax year 2000-01. Furthermore, the statutory auditors had not qualified the audited accounts for the tax years 2005-06 and 2006-07. Therefore, no set off is permissible for MAT purposes for the tax years in question.
- ▶ Permitting any set off for losses not appearing in the books of account will be contrary to the HC order sanctioning the reorganization and will amount to contempt of Court.

Tribunal's ruling

The Tribunal ruled in favor of the Taxpayer and held that set off of past years' book losses, as computed by the Taxpayer, were in accordance with MAT provisions for the following reasons:

- ▶ The book profit for MAT purposes should be based on the P&L a/c prepared in accordance with ICL. The downward adjustment for set off of past years' book losses should be based on losses as per books of account. The 'books of account' referred in the downward adjustment provision must be proper books of account which give true and fair view as required by the ICL and must comply with GAAP.
- ▶ If the statutory auditors have commented that a particular adjustment was not as per GAAP, the Tax Authority should take cognizance of such a comment and make necessary adjustments to align it with GAAP. The Apollo Tyres ruling is not contrary to this principle.
- ▶ In the present case, the Tax Authority has not disputed that the set off of debit balance in P&L a/c against Share premium and Revaluation reserve a/c is contrary to GAAP. Had the accounting treatment been as per GAAP, the books of account would have reflected accumulated losses. The Tax Authority is obliged to take cognizance of the statutory auditors' qualification for the past year which has direct and immediate bearing on the correct amount of past years' book losses available for set off in the current year.
- ▶ As regards the binding nature of the HC order sanctioning the reorganization, it cannot have a binding effect on the income tax assessment which needs to be made as per provisions of tax laws. The effect of accounting made in terms of the sanctioned scheme needs to be viewed independently from a tax perspective.

- ▶ Support was drawn from the Bombay Diamond ruling which had held that if the accounts are not prepared as per the ICL, the Tax Authority has the power to rework the book profit to bring it in line with the ICL.

Comments

It is well-settled by the Apollo Tyres ruling that for MAT purposes, the P&La/c prepared as per the ICL and approved by the statutory auditors, shareholders and the ROC is the starting point for computing book profit before making the statutorily permitted adjustments. The present ruling provides guidance that if the statutory auditors have commented on the non-compliance of such accounts with GAAP then such comments must be duly considered by the taxpayer and the Tax Authority.

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